

Exhibit 3

VCP – QUALIFIED PLAN

August 9, 2006

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VIA CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Internal Revenue Service
Attention: T:EP:RA:VC
P.O. Box 27063
McPherson Station
Washington, DC 20038

RE: San Diego City Employees' Retirement System
EIN: 20-1800126
VCP Control #: 911659038
IRC 415(b), (c) and (n) Issue

Dear Sir or Madam:

On July 12, 2005, the San Diego City Employees' Retirement System ("SDCERS") filed a request for a compliance statement from the Internal Revenue Service ("IRS") under the Voluntary Correction Program of the Employee Plans Compliance Resolution System pursuant to Revenue Procedure 2003-44. That filing was assigned control number 911659038. As indicated therein, that filing addressed only a correction with respect to the Presidential Leave Program. We have assisted SDCERS with a compliance review over the past months and, in the course of that review, have identified corrections necessary with respect to the requirements contained in Section 415(b), (c) and (n) of the Internal Revenue Code of 1986, as amended (the "Code"). This letter constitutes a supplement to the July 12th filing.

As this is a supplement to the original VCP filing, we have not repeated the basic information contained in that filing regarding the type of plan and the overview and history of SDCERS. Instead, this filing begins with the required information relating to the correction addressed herein. Capitalized terms used but not defined herein have the meanings attributed to them in the July 12th filing. Attached to this letter (as Exhibit 2) is the 415(b), (c) and (n) Compliance Strategy Report (the "Report"), which we prepared for SDCERS in the course of our compliance review. This document contains most of the information necessary for this filing. Therefore, in many places throughout this letter we have simply provided references to that Report. We trust this method of providing the information will be acceptable.

I. REQUIRED INFORMATION

A. Operational Failures

Exhibit F to the attached Report reflects the 29 instances in which the retrospective 415 testing conducted by SDCERS indicates that payments were made in excess of the 415(b) limits. This group reflects individuals who retired on or after January 1, 1995. The total overpayments were \$2,266,162.

B. Administrative Procedures in Effect at the Time the Failure Occurred

SDCERS has not historically conducted 415(b) or 415(c) testing. Therefore, there were no procedures in place.

C. Explanation of How and Why the Failures Occurred

The failures occurred because SDCERS had no monitoring or testing system in place in order to ensure that benefits were not paid in excess of the 415 limits. Exhibit F to the attached Report provides more detailed information regarding the amounts involved in each failure.

D. Description of Method for Correcting the Failure

SDCERS will take action to recover the excess benefits identified in Exhibit F to the attached Report, including interest as reflected therein, from the plan sponsors.

E. Description of How SDCERS Will Avoid Repeat Failures

Pages 29-30 of the attached Report, as well as Exhibits B through E to the Report, explain the process SDCERS is implementing for prospective 415 testing in order to ensure that further failures do not occur.

II. THE FOLLOWING CONFIRMS PREVIOUSLY SUBMITTED INFORMATION:

A. Statement Regarding Employee Plans Examination

Provided as Exhibit 1-A, Exhibit 1-B and Exhibit 1-C to the July 12th VCP filing.

B. Statement Regarding Determination Letter

SDCERS filed a determination letter application simultaneously with the July 12th VCP filing.

C. Statement Regarding Period for Correction

SDCERS tested all retirees currently receiving benefits who retired on or after January 1, 1995. This retrospective testing examined benefits paid from 1995 through June 30, 2005. Testing for the balance of 2005 and 2006 will be handled as a self-correction using the retrospective testing method.

D. Penalty of Perjury Statement

See attached Exhibit 1.

E. In support of this submission, the following documents were attached to the July 12th VCP filing:

1. A completed VCP Checklist from Appendix C of Revenue Ruling 2003-44, was submitted as Exhibit 3 to the July 12th VCP filing. In preparing this supplement and checking to ensure that it contained the correct information and documents required under Rev. Proc. 2003-44, we determined that the answers provided in the original VCP Checklist accurately reflect the responses with regard to this supplement. Therefore, we have not provided an additional VCP checklist.
2. The information required on the first three pages of the Form 5500, even though SDCERS is not required to file a Form 5500, was submitted as Exhibit 4 to the July 12th VCP filing.
3. A signed Form 5300, Application for Determination for Employee Benefit Plan, together with the applicable user fee and related determination letter application materials, was submitted as Exhibit 5 to the July 12th VCP filing.
4. A signed Form 2848, Power of Attorney and Declaration of Representative, authorizing the undersigned to represent SDCERS in connection with VCP submission, was submitted as Exhibit 6 to the July 12th VCP filing.
5. A check payable to the U.S. Treasury in the amount of \$25,000 for the required VCP fee was submitted as Exhibit 8 to the July 12th VCP filing.
6. A signed Statement Regarding Plan Documents was submitted as Exhibit 9 to the July 12th VCP filing.

F. In support of this submission, the following documents are attached:

1. Exhibit 1: Penalty of Perjury Statement.
2. Exhibit 2: Code Section 415(b), (c) and (n) Compliance Strategy Report prepared by Ice Miller LLP for SDCERS, including all attachments to that Report.

We believe that the information submitted is complete with respect to Code Section 415(b), (c) and (n) issues. If you have any questions or need additional information, please contact any of us at the telephone numbers listed above.

Internal Revenue Service

August 9, 2006

Page 4

Very truly yours,

ICE MILLER LLP


Mary Beth Braitman


Terry A.M. Mumford (AMB)


Katrina M. Clingerman (KMB)

Enclosures

cc: Carol Gold (hand deliver bound copy)
Joyce Kahn (hand deliver bound copy)
Louis J. Leslie (hand deliver bound copy and via email)
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Tony Santos (w/o attachments)
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EXHIBIT 1

PENALTY OF PERJURY STATEMENT

Under penalties of perjury, I declare that I have examined this submission, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of this submission are true, correct, and complete.

San Diego City Employees' Retirement System

By:

Name

Title

Robert L. Wilson
ASSISTANT RETIREMENT ADMINISTRATOR

EXHIBIT 2

**SAN DIEGO CITY EMPLOYEES
RETIREMENT SYSTEM**

415(b), (c), and (n) Compliance Strategy Report

**Mary Beth Braitman
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I.

INTRODUCTION

Ice Miller LLP ("Ice Miller") has been retained to provide a compliance review with regard to the Internal Revenue Code of 1986, as amended ("Code"), requirements applicable to the status of the San Diego City Employees' Retirement System ("SDCERS") as a qualified retirement plan under Code Section 401(a).

Ice Miller is not considering tax reporting and withholding under the Code nor any other federal law. We are also not deliberating any state law issues. Where state law must be considered, we are relying on interpretations provided by SDCERS counsel.

This report pertains to Code Section 415(b) and 415(c), and to Code Section 415(n) as it is related to 415(b) and 415(c). We have touched on Code Section 415(m) only with respect to the treatment of excess benefits under Code Section 415(b). We have prepared a separate briefing document for SDCERS on the topic of 415(m).

We have based this report on the material provided to us by SDCERS. We have not independently verified what has been provided to us. We are relying on SDCERS to provide us with documents, forms, and information necessary for this review.

II.

IMPORTANCE OF CODE SECTION 415 COMPLIANCE

A. SDCERS AS A QUALIFIED GOVERNMENTAL PLAN

Retaining "qualified plan" status under Code Section 401(a) is an important requirement for retirement plans. The primary advantages in retaining "qualified" status are that (i) employer contributions are not taxable to members as they are made (even when vested) and taxation only occurs when plan distributions are made, (ii) earnings and income are not taxed to the trust or the members; (iii) certain favorable tax treatments are available to members when they receive plan distributions, e.g., ability to rollover amounts; (iv) employers may "pick up" employee contributions; and (v) employer contributions to, and benefits from, the plan are never subject to employment taxes (i.e., FICA taxes). These advantages would generally not apply to a non-qualified plan.

B. CODE SECTION 415 LIMITS

One key qualification requirement applicable to qualified plans is the Code Section 415 limits. Code Section 415 benefit and contribution limits must be followed to protect the tax qualified status of a retirement plan under Code Section 401(a). These limits must be met by all plan members. If even one member is paid an annual benefit greater than Code Section 415 allows, or contributes more than Code Section 415 allows, theoretically, the entire plan will be disqualified.

C. PROPOSED REGULATIONS

On May 31, 2005, the IRS issued proposed regulations for Code Section 415 (the "Proposed Regulations"). The Proposed Regulations are mentioned below where their provisions are of particular interest or concern. However, given that it is expected that the IRS will finalize these regulations in 2006, and we anticipate some changes being made to the regulations as they move to final, we have not included an in-depth analysis of the Proposed Regulations in this overview. However, we have attached a summary of key areas addressed by the Proposed Regulations as Appendix A. Recently, the IRS issued Notice 2005-87, which states that the grandfather provisions contained in the Proposed Regulations will be expanded upon issuance of final regulations.

III. OVERVIEW OF LAW WITH RESPECT TO DEFINED BENEFIT LIMITATIONS

This Section of our Compliance Strategy Report provides an overview of the federal law with regard to Code Section 415(b). The impact of Code Section 415(b) on SDCERS and our specific recommendations for a compliance strategy are included in the next Section of this Report.

A. BASIC BENEFIT LIMITS

1. Current Limits

As amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the basic requirement of Code Section 415(b) is that the annual benefit in the form of a single life annuity provided to a member who is between the ages of 62 and 65 may not exceed the lesser of: (1) \$160,000 as adjusted for inflation in \$5,000 increments (the "Dollar Limit"), or (2) 100% of average compensation (the "Salary Limit"). Code Section 415(b)(1). For the 2006 calendar limitation year, the Dollar Limit is \$175,000. The Salary Limit does not apply to governmental plans such as SDCERS. Therefore, the following discussion and our methodology do not include the Salary Limit.

The Proposed Regulations would require that limits be applied on an annual basis to the accrued benefit. In Ice Miller's comment letter to the IRS with regard to the Proposed Regulations, we stated the following on this point:

We do have one overarching concern with the Proposed Regulations. They are fundamentally based on an annual accrual concept. For private sector plans this works well and is entirely consistent with the requirements and structure of Code Sections 411 and 412. However, these rules are not applicable to governmental plans, and, for most governmental plans, this concept does not work. In the governmental environment, vesting is generally determined by state law or local ordinances. In many cases, there is no "accrual" concept in the governing laws, but rather set benefits payable at certain events.

Therefore, we have prepared this compliance strategy report on the assumption that benefit testing for 415(b) purposes will be done at benefit payout.

2. Limitation Year

The annual benefit is tested in a "limitation year." Unless an election is made by the employer, the limitation year is the calendar year. Treas. Reg. § 1.415-2(b)(1). An employer that maintains more than one qualified plan may elect to use different limitation years for each such plan. Treas. Reg. § 1.415-2(b)(3).

B. TAMRA ELECTION

Section 415(b)(10) of the Code was added by the Technical and Miscellaneous Revenue Act of 1988 (sometimes called TAMRA) to offer state and local government plans a means of complying with the Section 415 limits without violating state anti-cutback laws. Under this Section, the defined benefit limit for an employee who became a participant in the plan before January 1, 1990, would not be less than his or her accrued benefit determined without regard to any plan amendment adopted after October 14, 1987. However, for a state or local government to take advantage of Section 415(b)(10), each employer maintaining the plan was required to elect, before the close of the plan year beginning in 1990, to apply the defined benefit limits applicable to private plans to employees who first became participants after 1990. However, there were also special provisions for state-wide statutory changes. For plans that made a TAMRA election, the qualified participants would still have their TAMRA protection.

C. AMOUNTS EXCLUDED FROM TESTING

For purposes of Code Section 415(b), the annual benefit means the benefit payable annually in the form of a straight life annuity (with no ancillary benefits), without considering payments made from a qualified excess benefit arrangement, after-tax employee contributions, and any rollover contributions. Code Section 415(b)(2).

1. Ancillary Benefits

"Ancillary benefits" do not count toward the benefits subject to Code Section 415. As a result, any benefit that is an ancillary benefit can exceed the 415 limits without the plan being disqualified. Generally, "ancillary benefits" are benefits not directly related to retirement income benefits. Ancillary benefits include "pre-retirement disability benefits and death benefits (such as in-service death benefits)." Code Section 415(b)(2)(B); Treas. Reg. § 1.415-3(c)(ii).

a. Pre-Retirement Disability Benefits

According to a non-precedential IRS Information Letter (IRS Information Letter on § 415 Limitations on Public Plans dated August 20, 1991 ("IRS Letter")) discussing Code Section 415 limitations on governmental plans, pre-retirement disability benefits under governmental plans are not taken into account under Code Section 415, even if the pre-retirement disability benefits exceed the "qualified disability benefit" limitations established in Code Section 411(a)(9). IRS Letter, § 1 Q&A-3; Treas. Reg. § 1.415-3(c)(ii). However, pre-retirement disability benefits are required to comply with Revenue Ruling 72-3, which prohibits a pension plan benefit from

exceeding 100% of the employee's compensation. For this purpose, the definition of the term "compensation" is similar to the definition identified in Code Section 415 and is subject to cost of living increases. Thus, there is still a test that needs to apply to pre-retirement disability benefits. Contrasted to pre-retirement disability benefits, post-retirement disability benefits must be taken into account for purposes of complying with the Code Section 415 limitations. IRS Letter, § 1 Q&A-4. Thus, (1) post-retirement disability benefits, (2) line of duty disability benefits paid post normal retirement date, and (3) pre-retirement disability benefits payable post normal retirement age will be tested under Code Section 415(b).

b. Pre-Retirement Death Benefits

Pre-retirement death benefits provided under a governmental plan are also exempt from the Code Section 415 limits. IRS Letter, § 1 Q&A-5; Treas. Reg. § 1.415-3(c)(ii). However, pre-retirement death benefits must meet the incidental benefit requirements of Code Section 401 and the regulations thereto. Generally speaking, death benefits are incidental where the plan provides a pre-retirement death benefit that is no greater than 100 times the monthly annuity benefit provided under the plan, or the cost of the death benefit does not exceed 25% of the total cost of all benefits for that participant. (This latter test would be one that would be analyzed by an actuary.) Revenue Ruling 74-307, 1974-2 C.B. 126.

2. Qualified Excess Benefit Arrangement ("QEBA")

Effective for years after December 31, 1994, state and local government employers may maintain "qualified governmental excess benefit plans" ("QEBA") under Code Section 415(m). Excess Plans are plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits. Excess Plans permit state and local government employers to provide benefits to their employees:

- (1) without jeopardizing plan qualification because of the limits on contributions and benefits under Code Section 415,
- (2) without jeopardizing a plan's status under Code Section 457 as an "eligible deferred compensation plan," and
- (3) without the income that accrues to the qualified governmental excess benefit plan being taxable to the plan's government sponsor.

As we have discussed, we will not be addressing Code Section 415(m) and QEBAs in detail in this report, but in a separate report. However, for the purposes of determining retrospective benefit testing protocols, we think that it is relevant to consider the following provision that accompanied the enactment of Code Section 415(m):

Nothing in the amendments made by this section shall be construed to imply that a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986) fails to satisfy the requirements of section 415 of such Code for any taxable year beginning before January 1, 1995.

P.L. 104-188. § 1444(c)(2). Under this grandfather section, retroactive testing for plan qualification purposes does not need to consider payments made prior to January 1, 1995.

3. Allocation of Benefits to After-Tax Employee Contributions

Contributions made on an after-tax basis to a defined benefit plan are deemed to be annual additions and subject to Code Section 415(c) limits (discussed below in more detail). Therefore, because the benefits have already been tested under Code Section 415(c), any portion of a defined benefit attributable to those after-tax contributions may be subtracted from the annual benefit before it is tested under Code Section 415(b). However, it is important to note that benefits that would be attributable to excess 415(c) contributions would not be "subtracted" from the annual benefit for 415(b) testing purposes.

a. Mandatory Employee Contributions

Treas. Reg. Section 1.415-3(d)(1) provides that the annual benefit attributable to mandatory contributions is determined by using the factors described in Code Section 411(c)(2)(B) "regardless of whether Section 411 applies to that plan." Regulations under Treas. Reg. Section 1.411(c)-1(c) establish the required method for allocating a portion of the defined benefit to the after-tax employee contributions for purposes of excluding this amount from the final annual benefit to be tested. The method requires calculation of the after-tax (not picked up) employee contributions (both mandatory employee contributions and any voluntary after-tax payments for service purchases unless tested under Code Section 415(n)), plus interest, at rates specified by the regulations. See Treas. Reg. § 1.411(c)-1(c). Generally, interest is computed at the rate provided by the plan until the last plan year before Code Section 411(a)(2) does not apply. Id. Thereafter, a plan should use a 5% interest rate factor.

Because governmental plans are exempt from Code Section 411, it is not clear how to apply this guidance to a governmental plan to which Section 411(a)(2) never applies. The Proposed Regulations provide that Code Section 411 should apply to this calculation even if the section is not applicable to the plan. Ice Miller commented on this point as follows:

Because governmental plans are always exempt from Code Section 411, it is not clear how to apply this guidance to a governmental plan to which Section 411(a)(2) never applies. We have not located any IRS guidance on point. A literal reading suggests that, since Code Section 411(a)(2) never will apply to a governmental plan, actual plan assumptions should continue to be applied. We think that this reading is the best approach in the governmental plan context.

b. Voluntary After-Tax Contributions

The rules governing mandatory employee after-tax contributions are also applicable to voluntary after-tax contributions. Treas. Reg. § 1.415-3(d)(3). However, a special category of voluntary after-tax employee contributions – for permissive service credit purchases – is discussed below.

4. Employee After-Tax Contributions for Permissive Service Credit

Code Section 415(n) establishes a limitation structure for "permissive service credit" purchases, instead of relying on the existing Code Section 415(c) defined contribution limitations. This subsection allows Code Section 415 to be satisfied by a purchase of permissive service credit if either a modified 415(b) limit is met or a modified 415(c) limit is met. These limits can be applied on a participant-by-participant basis rather than choosing to apply the limit on a plan-wide basis. For example, some participants could satisfy the modified defined benefit limit when making a purchase of permissive service credit, while others could satisfy the modified defined contribution limit.

a. Modified 415(b) Limit

For purposes of Code Section 415(n), the defined benefit limit in Code Section 415(b) may be met by treating the accrued benefit derived from all permissive service credit as part of the member's annual benefit. Code Section 415(n)(2)(A) provides that, where the dollar limit under 415(b) is reduced for retirement before age 62, "the plan shall not fail to meet the reduced dollar limit under Subsection (b)(2)(C) [the age-reduced dollar limit] solely by reason of this subsection." Thus, the plan will not fail to meet the age-reduced dollar limit solely because the accrued benefit derived from the permissive service credit purchase is included in the 415(b) test.

b. Modified 415(c) Limit

For purposes of Code Section, only the dollar limit under Code Section 415(c) applies (\$40,000 (adjusted for inflation to \$42,000 for 2005 and \$44,000 for 2006)) by treating all permissive service contributions as an annual addition under that limit.

c. Definition of Permissive Service Credit

The special testing rules apply only if the service being purchased qualifies as permissive service credit. Code Section 415(n)(3) defines "permissive service credit" as follows:

(3) **PERMISSIVE SERVICE CREDIT.**—For purposes of this subsection—

(A) **IN GENERAL.**—The term "permissive service credit" means service credit—

(i) recognized by the governmental plan for purposes of calculating a participant's benefit under the plan,

(ii) which such participant has not received under such governmental plan, and

(iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined under such governmental plan, which does not exceed the amount necessary to fund the benefit attributable to such service credit.

Code Section 415(n)(3)(A). The proper interpretation of the Code Section 415(n) definition of permissive service credit is not a settled term. The Proposed Regulations do not address 415(n) issues. However, in private letter rulings, the IRS has taken the position that a benefit enhancement purchase (buying a higher multiplier on service a member already has in a plan) is not permissive service credit, because it would be a purchase for service in a plan under which the member has already received credit for that service. See PLR 200229051. Further, it is the IRS's position that permissive service credit must be related to an actual period of service or employment.

d. Nonqualified and Qualified Permissive Service

Permissive service credit can be categorized into two types. First, the Code defines "non-qualified service" as all permissive service that does not fall within one of the itemized types listed in Code Section 415(n)(3)(C). Although the Code does not use this term, we have termed the types of service included in this list as "qualified permissive service."

Code Section 415(n)(3)(C) defines "nonqualified service" as all permissive service except for the following types of service (which we have designated "qualified permissive service"):

- Service (including parental, medical, sabbatical, and similar leave) for the US government, any state or political subdivision thereof, or any agency or instrumentality of any of the foregoing.
- Service (including parental, medical, sabbatical, and similar leave) for an educational organization which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12) as determined under state laws.
- Service for an association of employees of the U.S., state or political subdivision thereof, or an agency or instrumentality of the foregoing.
- Military service (non-USERRA covered) recognized by the governmental plan.

However, service under the first three (3) points above will be nonqualified service if recognition of the service would cause the member to receive a retirement benefit for the same service under more than one plan. Code Section 415(n) does not permit a plan to take more than five (5) years of nonqualified service into account, or to give members credit for any nonqualified service before the member has at least five (5) years of participation in the plan. Code Section 415(n)(3)(B).

It is important to note that "nonqualified service" is still one type of permissive service that is described in Section 415(n)(3)(A). Therefore, nonqualified service is available for purchase and may be tested under Code Section 415(n) special testing provisions.

e. Effective Dates

The service purchase testing provisions for permissive service credit under Code Section 415(n) are subject to a transition rule. The transition rule provides that the defined contribution

limits of Code Section 415(c) will not be used to reduce the amount of permissive service credit an "eligible participant" can purchase below what they were allowed to purchase under the terms of the plan as in effect on the enactment date, August 5, 1997. An "eligible participant" is an individual who first becomes a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of enactment) of the governing body with authority to amend the plan ends.

Because the term "permissive service" is used in the grandfather provision, we believe that the IRS would apply a consistent definition of permissive service credit to the transition rule. As a result, the transition provision could permit greater purchases of nonqualified service and could permit permissive service purchases that exceed 415(c) and (b) limits, but would not extend to the purchase of service that did not meet the definition of permissive service credit.

5. Picked-Up Contributions

It is important to note that pre-tax contributions ("picked-up contributions"), whether mandatory or voluntary, are not treated as post-tax contributions. The benefit attributable to picked-up contributions is subject to 415(b) testing.

a. *Code Section 414(h)*

For governmental plans, "where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions." Code Section 414(h)(2). Consequently, if a governmental employer correctly picks up employee contributions, such contributions will no longer be included in the employee's gross income, nor will they be subject to income tax withholdings. Treas. Reg. § 1.402(a)-1; Rev. Rul. 77-462, 1977-2 C.B. 358. However, such contributions may be treated as employee contributions for all other purposes, including calculating benefits, state taxes, cost of living increases, salary increases, and bonuses. GCM 39540; PLR 8630073.¹ In addition, certain pick-up contributions are taken into account as "wages" for FICA purposes. Code Section 3121(v)(1)(B). The only way to obtain confirmation that the IRS approves of a pick-up is through a private letter ruling.

Revenue rulings have established the following requirements for an effective pick-up:

- The employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee;
- The employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan; and
- The pick-up is not effective prior to the last action required to be taken by the employer and/or the employee.

¹ It is important to note that private letter rulings do not have precedential value for other taxpayers.

Rev. Rul. 81-35; Rev. Rul. 81-36; and Rev. Rul. 87-10.

b. Pick-ups of Service Purchases under Governmental Plans

The IRS has approved the use of pick-ups for contributions to purchase service credit under governmental plans that have sought private letter rulings. In order to meet the requirements for an effective pick-up of an employee's service purchase, the above requirements for a pick-up must be met plus the following:

- The employee must elect to have the contributions for the service purchase made pursuant to a binding and irrevocable payroll reduction authorization.
- The payroll authorization specifies the amount by which the employee's compensation will be reduced in order to purchase the service credit and the duration of the authorization.
- The authorization cannot be revoked, except in limited circumstances involving termination of employment or death of the employee.

The most recent IRS rulings on service purchase pick-ups have included the following limitation language:

This ruling is based on the conditions that (1) a participant who elects to purchase a particular type of service credit may not make more than one irrevocable election to purchase that type of service credit; and (2) a participant may make more than one irrevocable election to purchase service credit provided any subsequent election is for the purchase of a different type of service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase service credit.

PLR 200410025 (March 3, 2004); PLR 200347020 (November 7, 2003).

6. Amounts Attributable to Rollovers

Rollovers to a defined benefit plan are treated similarly to employee contributions for purposes of 415(b) testing:

If the benefit under the plan is payable in any form other than the form described in subparagraph (A), or if the employees contribute to the plan or make rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16), the determinations as to whether the limitation described in paragraph (1) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is equivalent to the benefit described in subparagraph (A).

Code Section 415(b)(2)(B). This provision was amended by EGTRRA and is not reflected in the current rules. However, the Proposed Regulations treat rollovers in a manner similar to after-tax

contributions, so that the benefit attributable to the rollover must be converted in accordance with prescribed factors.

7. Amounts Attributable to Transfers between Qualified Plans

Under the current regulations, amounts attributable to a transfer from a qualified plan (a plan under Code Section 401(a)) are not included for 415(b) testing purposes. Treas. Reg. § 1.415-3(d)(1). See PLR 200347020 (Favorable ruling to make transfers from state defined contribution plan to defined benefit plan to purchase service); PLR 200345042 (Favorable ruling to make transfers from state defined contribution plan to defined benefit plan to purchase service); PLR 200335035 (Favorable ruling to make elective transfer from grandfathered 401(k) to defined benefit plan of amount necessary to buy service credit; transferred amounts held separately).

However, under the Proposed Regulations, transfers between defined benefit plans that must be aggregated are included for 415(b) testing purposes. Prop. Treas. Reg. § 1.415(b)-1(b)(3)(i)(A). But see PLR 200411046 (Favorable ruling approving elections to participate in defined contribution, defined benefit or hybrid plan with plan-to-plan transfers available at member's option on initial election; transfer available on subsequent elections to buy service credit with certain transferred amounts.)

8. Plan-to-Plan Transfers from a 457(b) or 403(b) Plan

There is an open question as to whether transfers made from 457(b) and 403(b) plans could also be excluded. Currently, federal regulations limit this exclusion to transfers from qualified plans. However, Code Sections 403(b)(13) and 457(e)(17) permit a direct trustee-to-trustee transfer of amounts from a 403(b) annuity or a 457 deferred compensation plan to a governmental defined benefit plan to purchase permissive service credit (either qualified or non-qualified) as defined in Code Section 415(n)(3)(A) and to repay contributions and earnings with respect to a previous forfeiture of service credit as defined in Code Section 415(k)(3). The final Treasury Regulations for 457 plans make it clear that the IRS believes that the term "permissive service credit" for purposes of Code Section 457(e)(17) must be defined consistently with Code Section 415(n), although the limiting provisions of 415(n) do not have to be applied. In addition, the preamble to the Final Regulations raises another issue:

... Treasury and the IRS have concluded that section 415(n) does not apply to such a transfer in any case in which the actuarial value of the benefit increase that results from the transfer does not exceed the amount transferred.

68 F.R. 41232. The meaning of this comment is not clear and because the Proposed Regulations do not address Code Section 415(n), we do not currently have any guidance from the IRS as to whether a plan-to-plan transfer from a 457(b) or 403(b) plan to a qualified plan should be governed by the same rules as a plan-to-plan transfer from a qualified plan.

9. Restoration of Contributions

Code Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a

governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state. Thus, so long as the amount repaid does not exceed the amount refunded, plus interest, Code Section 415 should not apply. However, it is important to note that the Proposed Regulations do not agree with this interpretation, but rather treat the benefit attributable to the repayment as includible for 415(b) testing purposes. Prop. Treas. Reg. § 1.415(b)-1(b)(2)(ii).

D. AGE-BASED ADJUSTMENT TO LIMITS

1. Benefits Before Age 62

When the benefit begins before the participant reaches age 62, the Dollar Limit benefit limit generally must be actuarially adjusted so that the limit (as reduced) equals an annual benefit that is payable when the retirement benefit begins, and which is the equivalent of the Dollar Limit beginning at age 62. Code Section 415(b)(2)(C). The actuarial adjustments must be made in accordance with Code Section 415(b)(2)(E). Pre-EGTRRA, Code Section 415(b)(2)(F) limited the actuarial reduction for governmental plans to a \$75,000 benefit payable at age 55 or, if the benefit began before age 55, the actuarial equivalent of a \$75,000 benefit beginning at age 55.

a. Exception for Public Safety and Military

However, no age-based actuarial reduction is required for benefits beginning prior to age 62 for qualified participants. A qualified participant is defined as a participant:

- (i) in a defined benefit plan which is maintained by a State or political subdivision thereof,
- (ii) with respect to whom the period of service taken into account in determining the amount of the benefit under such defined benefit plan includes at least 15 years of service of the participant –
 - (I) as a full-time employee of any police department or fire department which is organized and operated by the State or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision, or
 - (II) as a member of the Armed Forces of the United States.

Code Section 415(b)(2)(G)-(H). The interpretation of this provision has caused some concern among public pension plans. For example, it was not entirely clear whether the qualified participant had to be a sworn officer of a police department or whether any employee of a police department would be covered by this provision. The Proposed Regulations offer some increased flexibility for a "qualified participant," which is defined as:

a participant in a defined benefit plan that is maintained by a state or local government with respect to whom the service taken into account in determining the amount of the benefit under the defined benefit plan includes at least 15 years of service of the participant ...[a]s a full-time employee of any police department or fire department that is organized and operated by the state or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such state or political subdivision.

Preamble to the Proposed Regulations. The proposed regulations would clarify that the application of this rule depends on whether the employer is a police department or fire department of the state or political subdivision, rather than on the job classification of the individual participant.

This exception is very beneficial to public safety officers and to other employees of police and fire departments, including non-public safety personnel. However, this definition does not cover employees who exercise police powers on behalf of a public agency but who are not employed by an agency that is called a "police department" (such as a Public Safety Department or Emergency Services Authority). An additional difficult situation arises with regard to emergency services personnel who are employed by an agency that is not called a "fire department" or "police department" but who are performing emergency medical services within the local government's jurisdiction. It remains to be seen whether the IRS will provide for further flexibility.

b. Exception for Disability and Death Benefits

In addition, the actuarial reduction for benefits beginning before age 62 does not apply to disability benefits or survivor benefits payable in the event of the death of the member provided under a governmental plan. Code Section 415(b)(2)(I).

c. Exception for Permissive Service Credit Procedures

A purchase of permissive service credit may be tested under Code Section 415(b) without regard to the reduction for early retirement.

2. Benefits After Age 65

For all members, if the retirement benefit under the plan begins after age 65, the Dollar Limit is increased so that it is the actuarial equivalent to an annual benefit beginning at age 65. Code Section 415(b)(2)(D). The actuarial assumptions used to make this conversion are set forth in Code Section 415(b)(2)(E).

E. ADDITIONAL SPECIAL RULES

1. Small Benefits

Code Section 415(b) has a number of additional special rules that may impact governmental employers. Code Section 415(b)(4) provides that defined benefit limits will not be

applied to reduce a participant's benefits when total annual benefits are \$10,000 or less. However, this limitation only applies "if the employer has not at any time maintained a defined contribution plan in which the employee has participated." Code Section 415(b)(4)(B).

2. Less than 10 Years of Participation

When an employee has less than ten years of participation in a defined benefit plan, the basic Code Section 415(b) Dollar Limit (or the minimum \$10,000 exemption from testing) is reduced by 10% for each year less than ten in which the employee participated in the defined benefit plan for other than death and disability benefits (but not below 1/10th of the Dollar Limit). Code Section 415(b)(5) and Treas. Reg. § 1.415-3(g).

F. OPTIONAL FORMS OF BENEFITS

Benefits in a form other than a straight life annuity must be actuarially adjusted to a straight life annuity beginning at the same age in accordance with the otherwise applicable rules. For example, annuity benefit forms including a post-retirement death benefit or an annuity providing for a guaranteed number of payments must be adjusted for purpose of applying the Code Section 415(b) limit. See Treas. Reg. § 1.415-3(c)(1)(ii). No adjustment is required for certain benefits, including the actuarial value of a qualified joint and survivor annuity ("QJSA") that is fully or partially subsidized, the value of benefits not directly related to retirement benefits, and certain cost of living increases. See Treas. Reg. § 1.415-3(c)(2).

Code Section 415(b)(2)(E)(i) provides that "for purposes of adjusting any limit under subparagraph (C) [adjustment to dollar limit before age 62] and ... for purposes of adjusting any benefit under subparagraph (B) [adjustment for other forms of benefits], the interest rate assumption shall not be less than the greater of 5% or the rate specified in the plan."² With respect to adjusting a different form of benefit (under Code Section 415(b)(2)(B)), different interest rate assumptions are used in the case of a form of benefit subject to Code Section 417(e)(3). Code Section 415(b)(2)(E)(ii). However, because SDCERS is a governmental plan which is not subject to Code Section 417(e)(3), these different interest rate assumptions would not be applicable. Rev. Rul. 98-1, Q&A-3 (plans that are not subject to Code Section 417(e)(3), such as governmental plans, are not subject to the interest rate requirement under Section 415(b)(2)(E)(ii)).

Thus, for purposes of converting a form of benefit to a straight life annuity, the interest rate assumption should not be less than the greater of 5% or the rate specified in the plan (i.e., the rate used under the plan for actuarial equivalence for that specific benefit form). See IRS Announcement 95-99.

G. COST-OF-LIVING ADJUSTMENT OF CODE SECTION 415(b) LIMITS

Cost of living adjustments to a member's benefits are permitted under Code Section 415(d) and Treas. Reg. § 1.415-5(a)(3). By regulation, the adjusted dollar limitation "is applicable to . . . employees who have retired or otherwise terminated their service under the

² Code Section 415(b)(2)(E)(iii) also provides that these same interest rate assumptions should be used in adjusting the 415(b) limit when benefits begin after age 65.

plan with a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive such benefits, as long as the plan specifically provides for the adjustment." Treas. Reg. § 1.415-5(a)(3).

With regard to the COLA on SDCERS benefits, the current regulations provide that no adjustment to the benefit's value is necessary for post-retirement cost of living increases "to the extent that such increases are in accordance with" Code Section 415(d) and Treas. Reg. § 1.415-5. Treas. Reg. § 1.415-3(c)(2)(iii). The correct interpretation of this phrase is a matter of some debate. IRS has said informally and in a private letter ruling that they think an automatic post-retirement increase must be initially reflected in the value of the member's benefit being tested, thus resulting in an initial actuarial reduction of the 415(b) limit. This reduction can be considerable. We do not think that this type of adjustment accurately reflects the regulations, which reflect an incremental approach – that a COLA does not cause an adjustment "to the extent" it is consistent with subsequent increases in the Code Section 415 limits. In addition, there seems to be no reasonable way to project what the increases to the IRS limit will be (by federal law the increases must be "similar" to the Social Security COLA calculations), making it virtually impossible to reflect an incremental COLA adjustment into a reduced 415(b) limit. Code Section 415(d)(2).

The Proposed Regulations incorporate the approach the IRS had taken in informal guidance and provide that a fixed, automatic COLA has the effect of reducing the 415(b) limit. As indicated, this reduction can be significant and would result in significantly more members of governmental plans approaching the 415(b) limit. Ice Miller and many others have submitted comments on this point, but it remains to be seen whether the IRS will address those comments by revising its stance in final regulations.

H. CONSIDERATION OF AN ALTERNATE PAYEE'S BENEFITS FOR TESTING PURPOSES

Benefits payable to an alternate payee under a qualified domestic relations order are treated as part of the member's benefit for purposes of applying the benefit limits under Code Section 415. IRS Notice 87-21, Q&A-20; see also Announcement 95-99, Q&A-17.

I. TESTING OF THE SURVIVOR PORTION OF A BENEFIT

The rules which apply to a member's benefit also apply to a survivor's benefit. Under Code Section 415(b)(1), the annual benefit may not exceed the applicable dollar limit (\$170,000 for 2005). The Code defines "annual benefit" as "a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions ... are made." Code Section 415(b)(2)(A) (emphasis added). If a benefit under the plan is payable in any form other than this form,

the determinations as to whether the [415(b)] limitation ... has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is the equivalent to the benefit described in subparagraph (A). For purposes of this subparagraph, any ancillary benefit which is not directly related to retirement income benefits shall not be taken into account; and that portion of any joint and survivor annuity which constitutes a

qualified joint and survivor annuity (as defined in section 417) shall not be taken into account.

Code Section 415(b)(2)(B).

Thus, the benefit that is subject to testing is a straight life annuity, and any other benefit under a plan which is payable in a form other than a straight life annuity (other than a qualified joint and survivor annuity) must be converted to a straight life annuity in order to pass 415(b) testing. In essence, even if a benefit actually being paid is not a straight life annuity, it still should have been converted to a straight life annuity and tested under Code Section 415(b). Thus, upon the death of the retiree, there would be no need for a "conversion" of the survivor's benefit or a change to the existing 415(b) limit as applied to the retiree's benefit. Rather, upon the death of a retiree, the survivor's benefit continues to be tested against the retiree's benefit limit. (This would also be true of a qualified joint and survivor annuity, even though it is not converted to a straight life annuity for testing purposes, because such benefit is exempted from the conversion requirement.)

J. AGGREGATION OF TOTAL SDCERS BENEFITS FOR TESTING PURPOSES

Under a multiple employer plan, two (2) or more employers that are not part of a related group participate in the same plan. In applying the Code Section 415 limits to such multiple employer plans, Treas. Reg. § 1.415-1(e)(1) provides that for a participant in a multiple employer plan, benefits or contributions under the plan attributable to such participant from all of the employers maintaining the plan and compensation from all the participating employers must be taken into account. Generally, if the employers had maintained separate plans this rule would not apply, and the Code Section 415 limits would be separately determined for each employer because they are not part of a related group.

IV.

APPLICATION OF CODE SECTION 415(b) TO SDCERS AND RECOMMENDATIONS

The purpose of this Section of this Compliance Strategy Report is to relate the requirements of Code Section 415(b) as outlined in the previous Section to SDCERS.

A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1010(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further establishes the calendar year as the testing year and permits SDCERS to modify contributions as necessary to ensure compliance with Code Section 415. The Board Rules do not contain any provisions relating to Code Section 415 compliance, nor do any other policies or documents of which we are aware.

B. OPERATIONAL COMPLIANCE

1. Definition of the Annual Benefit for 415(b) Testing

Under Code Section 415(b), the benefit that is subject to testing is the benefit payable annually in the form of a straight life annuity ("SLA") with no ancillary benefits to which employees do not contribute and no rollover contributions are made. Code Section 415(b)(2)(A).

a. Straight Life Annuity

The benefit that will be tested is the SLA plus the value of the DROP benefit (if applicable) on a straight life basis.

For purposes of calculating the SLA, the value of any subsidy provided as part of a qualified joint and survivor annuity was included only when the beneficiary was other than a qualified spouse. We understand that using the SDCERS "maximum benefit" would generally accomplish this purpose.

b. Post-Retirement Increases

SDCERS members receive two post-retirement adjustments: a fixed COLA and a 13th Check. Certain groups receive additional adjustments: a Supplemental COLA and benefit increases under the Corbett settlement. The protocols in Exhibit A and Exhibit B treat the fixed COLA as being within the Code Section 415(d) adjustment. With respect to the Supplemental COLA, 13th Check and Corbett Settlement, these benefits will be treated as part of the annual benefit for both prospective and retrospective testing. However, the value of the post-retirement \$2000 death benefit is not included for 415(b) testing. Treas. Reg. § 1.415-3(a)(2)(i)(B).

▪ 13th Check

In our various meetings, the question has arisen how to treat the 13th Check for testing purposes because under the Municipal Code the 13th Check is treated as a contingent benefit. In order to respond to the question, we considered the history of the 13th Check. From 1/1/95 to now, in all but two years the 13th check was paid in full. In 2003 no 13th Check was paid and in another year over 99% of the 13th Check was paid. Based upon this history, it was decided that for 415(b) testing purposes, the 13th Check will be treated as an additional annual benefit. (Note: This is consistent with the treatment described in the Rollover Compliance Report and VCP Filing.)

▪ Supplemental COLA

For 415(b) testing purposes, the supplemental COLA is already treated as an annual benefit. This benefit is referred to in the testing chart as the "Star COLA."

▪ Corbett Settlement Amounts

For purposes of 415(b) testing, the Corbett settlement amount will be treated as part of the annual benefit.

The Corbett-covered group is a closed group.

▪ **Andrecht Settlement Amounts**

The Andrecht Settlement amounts were included in the calculation of the annual benefit provided by SDCERS. Therefore, no additional adjustment is required for this settlement (in contrast to the Corbett Settlement, which is a post-retirement adjustment).

c. Factors used in Calculating Actuarial Equivalents

Where necessary to calculate actuarial equivalents, the applicable mortality assumptions of GAM 83 through December 31, 2002, and thereafter GAR 94, pursuant to Rev. Rul. 2001-62, 2001-2 C.B. 632, were used. An eight percent (8%) interest assumption was used.

d. Exclusion of Recipients of Ancillary Benefits

It has been determined that individuals who are receiving benefit payments that are not directly related to retirement benefits (such as pre-retirement disability and death benefits and post-retirement medical benefits) will be excluded from testing.

SDCERS also anticipates excluding all non-taxable disability benefits (these would be line of duty disability benefits). However, we note that an IRS ruling is necessary as to the status of these items and we are not aware that SDCERS has ever obtained such a ruling.

For the pre-retirement disability benefits, SDCERS will still have to apply the 100% of compensation screen. For the combined pre-retirement disability benefit and the pre-retirement death benefit, SDCERS will apply an incidental benefit test, such as the 25% of cost test. This will be in addition to, and separate from, the 415 limits.

2. **TAMRA Election**

SDMC § 24.1010(b) (*prior to pending amendment*) purports to make the TAMRA election for SDCERS benefits. However, the pending amendment to SDMC § 24.1010 would remove the language referencing the TAMRA election, as it is not clear that the requirements of the election were satisfied. We recommended that the TAMRA election should be treated as repealed because it would impose the private sector plan limits on certain SDCERS members, and because it is our understanding that SDCERS operated as though the TAMRA election had been repealed.

3. **Age Adjustments Made in 415(b) Testing**

a. Benefits After Age 65

For all members whose retirement benefit begins after age 65, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

b. Benefits Before Age 62 – Other than Qualified Participants

For all members other than Qualified Participants whose retirement benefit begins before age 62, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

c. Definition of Qualified Participants

As discussed above, the reduction in the dollar limitation for benefits which begin before age 62 does not apply to Qualified Participants. It is important to keep in mind that the group of public safety employees who may take advantage of this exception is not necessarily consistent with SDCERS' public safety member classification. For example, since EMTs were moved into the fire department several years ago, they could be included as a Qualified Participant (if they meet the service requirements). However, lifeguards were moved into the fire department fewer than 15 years ago; therefore, they do not clearly fall within the exception.

We note that the Proposed Regulations provide further guidance as to the public safety employees who may take advantage of the exception. Following is a suggested checklist for identifying Qualified Participants:

- Is the member credited in SDCERS with at least 15 years of service as an employee of any police department or fire department of the employer? If no, then apply pre-age 62 screen. If yes, proceed to next question. Note: The 15 years must be with an SDCERS employer, not via reciprocity.³
- Was the member a full-time employee of any police department or the fire department for all of those 15 years of service? If no, then apply pre-age 62 screen. If yes, do not apply pre-age 62 reduction. Count a person as a full-time employee of the department even if they are not a public safety officer. For example, if a person was a secretary in the fire department, they are a Qualified Participant. Service with the departments should be counted, including all periods of service, e.g., count such service that occurred before termination and reemployment. For example, if a member worked on probation for his first six months and then purchased that time, it should be included. A second example is a person who worked for one of the departments for three years, then left and took a refund. He then returned to the department and purchased those three years. They should be included.

SDCERS staff has asked whether this exception for public safety officers requires that all fifteen (15) years of service be with the same department, or whether the service might be spread among two or more departments. In addition, SDCERS staff has asked whether police and military service can be combined to meet the 15-year requirement. The language of the Code and related regulations are very ambiguous on this point. While the Code language requires fifteen (15) years of service for any police or fire department organized and operated by the

³ If the City plan, the Airport plan, and the Port plan are considered as separate plans, the Proposed Regulations may not permit combining service.

governmental employer maintaining the plan or military service, the Proposed Regulations require service either for any police or fire department or military service. Therefore, we are unable to opine on this point, although we believe that the IRS should accept any combination of public safety and military service in reaching the 15 year mark. We therefore are comfortable with the testing being done using the combination of all San Diego police and fire department service and military service. The IRS, of course, may request a different approach in the VCP filing on Code Section 415(b).

In addition, we agreed we would add a discussion of park rangers, who are not in the police department, but who exercise police powers in the City parks. We believe that the IRS should treat them as qualified participants if they meet the 15-year test. Therefore, we should identify this group under the definition of qualified participants.

d. Exclusion of Pre-Age 62 Reduction for Disability or Death Benefits

The pre-age 62 reduction would not be applied to a SDCERS disability benefit or to a death benefit.

4. 10-Year Adjustment

SDCERS must identify those retirees who have fewer than ten (10) years of service with SDCERS, exclusive of reciprocity and exclusive of service purchases. Those retirees would have a reduced 415(b) test amount – for example, if the retiree only had five (5) years of service with SDCERS (exclusive of reciprocity and service purchases), the retiree's age-adjusted limit would be 50% of the age-adjusted limit. The limit can never be lower than 10% of the otherwise applicable limit. We realize this could create failures because of several design elements (*i.e.*, the Port and Airport Plans have a five year vesting schedule, reciprocity provisions that allow for crediting service in other plans, a pre-1992 group who had less than 10 years of service but were vested as a mandatory retirement age group, and the SPSP "5+5" group). These adjustments are described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

C. AMOUNTS EXCLUDED FROM TESTING

Following is a discussion of the elements that have been considered for exclusion in the screening and testing process.

1. After-Tax Employee Contributions

SDCERS would normally identify the portion of the annual benefit that is attributable to after-tax employee contributions, which benefit could be "subtracted" from the annual benefit. In order to perform this calculation, SDCERS would have to be able to identify mandatory employee contributions that were made prior to the adoption of the pick-up and any voluntary post-tax contributions (including after-tax contributions for service purchases). However, we ultimately recommend that in the testing protocol the benefit attributable to after-tax employee contributions not be excluded from 415(b) testing, because those after-tax contributions were not tested under 415(c). This would be consistent with Code Section 415(n) testing.

a. Mandatory Employee Contributions

SDCERS implemented a pick-up of mandatory contributions in 1987⁴ for all contributions made by the employer. Prior to that time mandatory employee contributions were made on an after-tax basis; therefore, under the IRS regulations the benefit attributable to those mandatory contributions would be excludible from 415(b) testing. However, if those mandatory contributions exceed the 415(c) limits, the benefit attributable to the excess contribution would not be excludible. These pre-87 contributions will only be "backed out" from the 415(b) testing in cases where a failure has been identified in the testing group under the prospective methodology. The initial screen will leave them in.

b. Voluntary USERRA Contributions

It is our understanding that USERRA contributions are subtracted from any differential pay for the member. However, if the member did not receive differential pay, the member would be given the opportunity to pay those contributions on an after-tax basis. Therefore, SDCERS would be permitted to exclude the benefit attributable to the post-tax USERRA contributions from 415(b) testing, if the post-tax USERRA contributions would not have exceeded the 415(c) limits in the year of service.

c. DROP Contributions

SDMC § 24.1404(c)(4) provides that DROP contributions are made pursuant to a 414(h) pick-up. Therefore, the benefit attributable to these contributions would be included in 415(b) testing.

d. Voluntary Contributions for Permissive Service Credit Purchases; Missed Contributions

As noted above, the amount contributed for permissive service credit may either be tested under a modified 415(c) or 415(b) test. If the permissive service credit purchases exceeded the modified 415(c) limit, then the modified 415(b) test would have to be applied.

When SDCERS has determined that contributions have not been remitted for a period of service, the member is "billed" for these contributions as a pre-condition for receiving credit for that period of service. If those missed contributions are paid by the member with after-tax dollars, those contributions would be tested under Code Section 415(n) using the modified 415(b) test.

e. Voluntary Contributions for Non-Permissive Service Credit Purchases

Voluntary employee after-tax contributions that are made for non-permissive service credit purchases must be tested under Code Section 415(c). If those voluntary after-tax contributions were appropriately tested under Code Section 415(c) at the time of purchase, the benefit attributable to those contributions may be excluded from 415(b) testing.

⁴ This date was provided by staff on 12/7/2005.

f. Proposed Correction Approach

Because SDCERS has not had a 415(c) testing program in place prior to this compliance review, we have suggested as a correction approach that no after-tax employee contributions would be excluded from 415(b) testing. See Exhibit A.

Starting with January 1, 2007, and on a prospective basis, 415(c) testing will be applied. Testing for 2006 will be handled in a self-correction manner. We also recommend, as a going-forward matter, that SDCERS keep a record of the type of service purchased and the source of the purchase. This will be done by reprogramming PensionGold (the SDCERS operating system).

PensionGold currently has fields with drop down selections that are used to identify the sources of money received for the payment of Purchase Service Contracts:

Payment Type Choices:

- 401k Transfer
- Balance Adjustment
- Cashless Transfer⁵
- Lump Sum Payment
- Manual
- Rollover
- SPSP Transfer
- Transmittal

If the Rollover option is selected as the Payment Type, the "Rollover information" section is enabled. This section has a "Type" field with the following selection options:

- 401(k)
- 403(b)
- 457
- Individual Retirement Account
- Other Qualified Plan

Other fields in the Rollover information section include:

- Acct. Name
- Acct. Number
- Acct. Holder

Each Payment received is identified in the system as "Pre or Post tax," as well as tied directly to a specific contract which identifies the service purchase type.

⁵ This type of transfer is addressed in a separate VCP filing and Report.

To provide for accurate prospective 415(c) testing, we recommend that an additional payment type be identified as 457(b) or 403(b) direct transfer to identify those situation where permissive service credit is being purchased. We also recommend that the specific type of service being purchased be identified so that it can be determined that an appropriate source of funding was used.

2. Rollovers

The amount of the annual benefit that is attributable to rollovers may be excluded from 415(b) testing. As noted above, the benefit attributable to a rollover must be calculated in a manner permitted by the IRS. The properly calculated benefit attributable to the rollover could be "subtracted" from the annual benefit for testing purposes. Appropriate conversion factors for rollover purchases will be utilized.

3. Transfers from a Qualified Plan

With regard to transfers from a qualified defined contribution plan, the amount attributable to the transfer would be excludible from 415(b) testing using IRS prescribed factors. However, if there is a transfer from another defined benefit plan where aggregation is required (because, for example, the plans are maintained by the same employer or related employers), then the total benefit would be tested under 415(b). If the transfer is not from a defined benefit plan where aggregation is required, then the benefit attributable to the transferred amount could be "subtracted" from the annual benefit for testing purposes. Appropriate conversion factors for transfers in this situation will be utilized. **Note:** In this case, the employers participating in SDCERS do not maintain another defined benefit plan.

4. Transfers from a 403(b) or 457(b) Plan

Current IRS guidance does not directly address a transfer from a 457(b) or 403(b) plan for testing purposes. Retrospectively, we are not backing out 457(b) and 403(b) transfers. Prospectively, the chart below will be followed.

5. Purchase of Service Chart

The following chart identifies the various purchases that may be made under the Municipal Code⁶ and our assessment of whether they would appropriately be categorized as permissive service credit – qualified or non-qualified – and the types of contributions that could be used for the purchase. For the category "permissive service," we are assuming that SDCERS assures that there is no double-counting of service and only one year of credit may be received for any 12 month period. For the category "sources" we are referring to whether all types of employee contributions can be made for the purchase – after-tax contributions under 415(c), after-tax contributions under 415(n), rollovers, plan-to-plan transfers from a DC qualified plan, and plan-to-plan transfers from a 457(b) or 403(b) plan. With respect to transfers, the final 415 regulations may offer more guidance for prospective testing.

⁶ Board Rules 10.00-10.40 describe Board policy with respect to the purchases that are set forth in the Municipal Code.

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
Missed Contributions	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1301 – LTD	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1302 – Probation. Employee contributions only	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – City Service	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – 1981 Plan – waiting period	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1304 – Part-time, hourly pre 1/2/97	Yes (no double counting)	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1305 – Reinstatement – pre	Yes (no double counting)	Qualified	All	Back out benefit attributable to rollovers,

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
1/2/97	415(k) Service			DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1306 – Repayment of refunds – contributions plus interest	Yes 415(k) Service	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(a) – Approved leave (one year) by payment of "employee cost" for leaves that begin before 2/1/97	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(b) – Approved leave (more than one year) by payment of employee and employer cost for leaves that begin before 2/1/97.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(c) – After 1/1/97, LTD, FMLA, leaves without pay.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1308 – Field of Membership	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1309 – Military Service: USERRA service (Per	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b)

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
SDCERS, this only covers USERRA service.)				transfers, based on IRS factors; use modified 415(b) testing under 415(n). Note: Electing this for convenience could be treated separately from all other service.
24.1312 – 5 year purchase – No period of service identified	Not permissive service	n/a	Rollovers, DC transfers, picked up contributions, after-tax employee contributions	For rollovers and DC transfers, back out benefit attributable to rollovers and DC transfers, based on IRS factors. For after-tax employee contributions, test under 415(c) regular limits
24.1312 – 5 year purchase. If a period of service is identified, then purchase may be made with after-tax employee contributions	In order to be permissive service credit, IRS non-binding ruling requires period of service or employment. New Board Rule 10.60 establishes procedure for definition as permissive service	Depends on certification provided – may be qualified or nonqualified permissive service. If non-qualified may only be purchased by employee with 5 years of service and total purchase may not exceed 5 years.	After-tax employee contributions	Use modified 415(b) testing under 415(n).
24.1312 – 5 year purchase – A period of service identified – purchase is made with 457(b) or 403(b) transfer	In order to be permissive service credit, IRS non-binding ruling requires period of service or employment. New Board Rule 10.60 establishes procedure for definition as permissive	N/A	Transfer from 457(b) or 403(b) plan	Back out benefit attributable to 457(b)/403(b) transfers, based on IRS factors * Use modified 415(b) testing under 415(n).

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
	service			

6. 401(h) Amounts

Payments made from the 401(h) account do not count toward the Code Section 415(b) limit. Treas. Reg. § 1.415-3(d)(2)(ii). However, Code Section 415(l) provides that contributions allocated in an "individual medical account" shall be treated as an annual addition to a defined contribution plan, but are only subject to the 415(c) dollar limit (not the compensation limit).

However, it is our understanding there are currently no SDCERS reserves left to pay this 401(h) benefit. Consequently, retiree medical is either paid from other sources or not paid at all.

7. Aggregation of Payments to Alternate Payees

For purposes of 415(b) testing, SDCERS must aggregate payments to the member with any payments to alternate payees under the community property laws, including payments made pursuant to child support and spousal support orders. PensionGold was modified as of January 1, 2003, so that all payments made with respect to a member are "associated" with the member. In addition to payments to alternate payees, the "association" also includes deductions from the member's benefit such as an IRS levy. In order to have accurate 415(b) testing both prospectively and retrospectively, all "disassociated" payments must be associated with the appropriate SDCERS member. That "association" was done only with respect to the "initial failure" group of 89. (Please note that the initial group screen did include a 20% load for other than member payments.) Therefore, the total population has not been "associated." The 89 initial failures were "associated." Prospectively, SDCERS must associate all members when tested.

D. CLASSIFICATION OF EMPLOYER CONTRIBUTIONS

SDCERS staff has indicated that the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution. The result is that the benefit attributable to any employer contribution (regular, offset, and pick-up) will be subject to 415(b) testing. This is the appropriate result under Code Section 415(b).

In order to enhance future compliance efforts, we strongly recommend that SDCERS and the plan sponsors use the term pick-up in the manner provided for in Code Section 414(h)(2).

E. QUALIFIED EXCESS BENEFIT ARRANGEMENT ("QEBA")

We note that Ordinance No. O-18390, adopted on March 19, 2001, authorizes the establishment of a qualified governmental excess benefit arrangement (known as the Preservation of Benefit Plan) by SDCERS to pay benefits in excess of the Code Section 415 limitations. SDMC §§ 24.1601 to 24.1608 provide basic provisions regarding the establishment of a QEBA. However, we understand that there was no separate plan document for the QEBA

and the above-referenced provisions of the SDMC do not contain sufficient detail to address all aspects of the operation of the QEBA. For these reasons, we recommended during our September discussions that SDCERS establish the QEBA through a separate plan/trust document containing detailed provisions regarding the plan. That document has now been drafted. This is covered in a separate report, and will be submitted to the IRS in a PLR.

F. CONCLUSIONS REGARDING RETROSPECTIVE 415(b) TESTING

1. Definition of Tested Group

SDCERS, working with Ice Miller and Cheiron, developed a protocol for determining whether there have been 415(b) violations in prior years. This protocol began by identifying the entire population of 5530 retirees. That total was initially reduced by disabilitants who were not receiving a service retirement (490). The group was then reduced to retirees who began receiving benefits on or after January 1, 1995. After removal of 26 records reflecting deceased or suspended participants, this remaining group consisted of 2041 individuals, who were then tested under 415(b). See Exhibit A for the assumptions that were used in testing this group. This date (1/1/95) was selected for the following reasons:

From a Benefit Standpoint

1. The DROP benefit is one of the potential "causes" of 415(b) failures. The DROP benefit was initiated after January 1, 1995 (April 1997). Therefore, all DROP recipients are being tested under the new protocol.
2. Using the 1/1/95 date captures all of the Corbett and Andrecht settlement amounts.
3. Service purchases are another potential cause of 415(b) failures. The largest service purchase programs were initiated after January 1, 1995.
4. Multiplier increases are another potential cause of 415(b) failures. The most recent multiplier increases took effect in 1997 and 2002.

From the Code Standpoint

1. The grandfather provision enacted with Code Section 415(m) applies to benefits prior to January 1, 1995.
2. The grandfather provision enacted with Code Section 415(n) applies to any service purchase in effect on August 5, 1997.

2. "Screens" Used in Retrospective Testing

a. *First Screen*

Cheiron has run its 415 testing at 90% of the applicable 415(b) limit with the assumptions set forth in Exhibit A and discussed above. This first screen was conservative:

- It tested the benefit derived from all contributions, including rollovers, plan-to-plan transfers, pre-tax employee contributions and mandatory contributions, service purchases, and employer contributions.
- It did not apply the more favorable age-reduction rules for qualified public safety participants.
- It included DROP accruals computed based upon the actual option selected by the member.
- It reflects the annual benefits, which were adjusted by a 20% increase to take into account co-annuitant issues.

This first screen resulted in approximately 89 persons being identified as exceeding the 415(b) limits, out of a pool of 2,041 benefit recipients.

b. Second Screen

These 89 individuals were re-examined by SDCERS staff and Cheiron by doing the following:

- Identify rollover and transfer amounts that were used for service purchase for service retirement, so that the benefit attributable to those rollover amounts could be backed out of the benefit calculation.
- Identify transfer amounts (from the DC plans, i.e., the SPSP and the 401(k) Plan) that were used for service purchase for service retirement, so that the benefit attributable to those transfers could be backed out of the benefit calculation.
- On the joint and survivor elections - if the benefit is a qualified (spouse) survivor annuity (either 50% or 100%), test under more favorable rules under Code.
- Check if any of the failure participants have QDROs which have to be aggregated and, if so, aggregate the benefits.
- Determine the member's service history -- what departments did the member actually work in. The purpose would be to determine if the member should be categorized as public safety. As discussed above, we suggested including those with 15 years in either a police or fire department. As we have indicated above, the qualified participants do not have to be sworn. Service purchases, other than purchases of public safety employment (such as probationary service or restored time), do not count toward the public safety years. Service purchases of public safety employment do count.

The second screen did not exclude from testing any after-tax employee contributions, whether mandatory or voluntary. The second screen also did not include transfers from the 457(b) plan or from a DB plan.

The resulting number of 415(b) violations was 29.

3. Payments of Excess Benefits from the Preservation of Benefit Plan

After completion of the above screens, the excess benefits of the affected individuals will be paid by the plan sponsors pursuant to San Diego Municipal Ordinance O-18930, March 19, 2001 (the "Ordinance"), which establishes the Preservation of Benefit Plan ("POB Plan") as a qualified governmental excess benefit arrangement within the meaning of Code Section 415(m).

We have recommended to SDCERS that a private letter ruling be pursued in order for the IRS to approve the POB Plan as a qualified excess benefit arrangement under Code Section 415(m) and to approve a rabbi trust for the POB Plan under Rev. Proc. 92-64, 1992-33 I.R.B. 11. In the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits.

Once the POB is in place, SDCERS staff wants to use a "modified cliff approach." Under this approach, a retiree would be paid his/her full monthly benefit from the qualified SDCERS plan until the "modified cliff" date is identified. The modified cliff is determined by first identifying the amount of 415(b) excess for the year and determining how many months of benefits would have to be paid from the POB. Then, that amount is further adjusted to make sure that the member is receiving a portion of his/her benefit from the qualified plan in order that deductions from that benefit can continue.

A very simplified example demonstrates this approach: assume that a retiree is receiving a straight life annuity and has an excess benefit that equals 1/12 of his annual benefit. That would mean that he would receive 11 months of benefit from the qualified plan and one month of benefits from the POB. But if the retiree has a deduction from his benefit that equals 1/2 of his monthly benefit, then he would receive 1/2 of his monthly benefit from the qualified plan in month 11 and month 12 (in order to have dollars available for the deductions to take effect) and he would receive 1/2 of this monthly benefit from the POB in month 11 and month 12.

G. CONCLUSIONS REGARDING PROSPECTIVE TESTING

1. Definition of Tested Group

Retrospective testing will cover the period 1995 through June 30, 2005. Testing for the balance of 2005 and 2006 will be handled as a self-correction using the retrospective testing method.

All members who retire on and after January 1, 2007, will be tested in accordance with the 415(b) protocols being developed by Cheiron, a draft of which is set forth in Exhibit B. To the extent information is available on pre-pick-up employee contributions, the after-tax contributions will be backed out for 415(b) testing.

2. **"Screens" Used in Testing**

Linea will build screens based upon PensionGold (the software used by SDCERS) fields.

3. **Payments of Excess Benefits from POB Plan**

Payments of excess benefits that result from prospective screening will be accomplished as stated above.

V.

**OVERVIEW OF LAW WITH RESPECT TO
DEFINED CONTRIBUTION LIMITS**

Annual additions made or deemed to be made to a defined contribution plan are subject to the limits under Code Section 415(c). This test is applied on an annual basis and it is applicable to those governmental defined benefit plans that provide for after-tax employee contributions or certain purchases of service. Thus, after-tax employee contributions and after-tax payments for purchases of service are tested under the Code Section 415(c) limits, in the same manner as contributions to a separate defined contribution plan. Treas. Reg. § 1.415-3(d)(1).

A. **THE DOLLAR LIMIT ON "ANNUAL ADDITIONS"**

1. **Current Limits**

The defined contribution limits contain both a Dollar Limit and a percentage of compensation limit ("Percentage Limit"). EGTRRA increased the Dollar Limit for defined contribution plans from \$35,000 to \$40,000 for plan years beginning in 2002. This \$40,000 dollar limit is subject to more rapid indexing, with annual cost of living adjustments in \$1,000 increments instead of the current \$5,000 increments. For 2006, the limit is \$44,000.

Under prior law, the Percentage Limit did not permit contributions to exceed 25% of compensation. However, EGTRRA amended this limit for plan years beginning in 2002, and permitted annual additions to defined contribution plans of up to 100% of the participant's compensation, or \$40,000 (as adjusted for inflation), whichever is less. For purposes of this definition, "compensation" includes both elective deferrals to a 401(k) plan or 403(b) plan and amounts contributed or deferred by the employer at the employee's election under a cafeteria plan, qualified transportation fringe benefit plan, or a 457 deferred compensation plan.

Certain contributions are not included in the definition of "annual additions" that are tested under Code Section 415(c). Mandatory employee contributions that are picked-up by an employer, or service purchase payments paid for by pre-tax (picked up) installment payments, simplify Code Section 415 testing because mandatory contributions or service purchase installment payments picked up pursuant to Code Section 414(h)(2) are not required to be treated as contributions to a separate defined contribution plan. However, the resulting benefit must be tested under Code Section 415(b) upon separation.

Additionally, Treas. Reg. § 1.415-6(b)(2) provides that a transfer of funds from one qualified plan to another is not an "annual addition" subject to testing under Code Section 415(c). Furthermore, Treas. Reg. § 1.415-6(b)(3) provides that the following types of contributions are not treated as employee contributions and thus are not "annual additions":

- (i) Rollover contributions, and
- (ii) The direct transfer of employee contributions from one qualified plan to another.

Additional exceptions from the 415(c) limits include USERRA contributions and restoration of forfeited benefits, which are discussed below.

2. The Limitation Year

The limitation year for 415(c) testing purposes is determined in the same fashion as for 415(b) testing purposes.

3. Code Section 415(k)(3): Repayment of Cash-Outs

Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state.

4. Testing of USERRA Service Purchases

Special Code Section 415 testing rules apply to the payment of contributions covered by the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"). Pursuant to Code Section 414(u)(1)(A) and (B), payments made in the applicable USERRA "make-up" period shall not be included in the Code Section 415(c) test for the calendar year in which the payment is made, and shall instead be allocated to the calendar year for which it relates. This rule exists to address a situation in which make up contributions permitted by USERRA for multiple years, in addition to the regular on-going contributions, were all made at once upon the return of a plan member on USERRA-approved leave. If the Code Section 415(c) limits were applied to the sum of these contributions, then a member might exceed the applicable limit.

In SDCERS' case, generally in "real life," the employee is being paid differential pay while on military leave, so their regular deductions for contributions remain as is (on a pre-tax basis). For the few employees who do not receive sufficient pay throughout the period to remain current on contributions, they are given options on how to restore contributions (e.g., lump sum installments). This group may need to be moved to an Exception Management process.

5. Code Section 414(v).

Code Section 414(v) provides that an "applicable employer plan" may permit an eligible participant to make additional elective deferrals in any plan year subject to certain limits. An

"applicable employer plan" includes a 401(a) plan, a 403(b) plan, a SEP or a SIMPLE IRA, and a 457(b) plan. An eligible participant means a participant in the plan who will attain age 50 in the plan year and who would otherwise be "capped" out by other Code limitations. These additional elective deferrals may not exceed the lesser of the "applicable dollar amount" (for 2006 and thereafter this amount is \$5,000) or the difference between the participant's compensation minus all other elective deferrals. For purposes of applying this limit, all 401(a) plans, 403(b) plans, SEPS and Simple IRAs of a single employer must be aggregated. Multiple 457(b) plans of a single employer must be aggregated, but are not aggregated with the other types of employer plans.

An additional elective deferral under Code Section 414(v) will not be subject to the otherwise applicable limitation under Code Section 401(a)(30), 402(h), 403(b), 408, 415(c), and 457(b) (determined without regard to 457(b)(3)).

Therefore, in determining whether an SDCERS member who makes an after-tax employee contribution is violating the 415(c) limits, the member's 415(c) limit is determined without regard to any additional elective deferral made under Code Section 414(v).

B. DEFINITION OF COMPENSATION

1. General Rule

Code Section 415(c)(3)(A) defines "participant's compensation" as "the compensation of the participant from the employer for the year." Code Section 415(c)(3)(D) includes as compensation elective deferrals under Code Section 402(g)(3) and amounts contributed by the employer at the election of the employee which are excluded from income under Code Sections 125, 132(f)(4), or 457.

Treas. Reg. § 1.415-2(d)(2) provides the following definition of compensation:

For purposes of applying the limitations of section 415, the term "compensation" includes all of the following:

(i) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income

(iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

Code Section 104(a)(1) excludes from gross income amounts received under workmen's compensation acts as compensation for personal injuries or sickness.

2. Safe Harbor Definitions

There are at least three safe harbor options available to a plan for purposes of defining compensation for Code Section 415(c):

- (1) Define compensation on a person by person basis, including all taxable income and certain items not included on Form W-2, imputed income items, etc. This approach has the advantage of producing the highest possible compensation amount for each individual, but is not administrable for a plan of any size. In order to take this approach, it would be necessary for SDCERS to determine the tax treatment of domestic partner health coverage and various other items.
- (2) Define compensation based on the number reported by the employer as gross income in Box 1 of each employee's Form W-2. This approach results in a lower number than method 1, but is much easier to administer.
- (3) Define compensation based amounts subject to federal income tax withholding, but excluding taxable reimbursements and the cost of group-term life coverage. This approach also results in a lower number than method 1, but is generally easily available from the employer or payroll service provider and is therefore much easier to administer than an individualized approach.

3. Treatment of Workers Compensation

Plans often question how to treat workers compensation payments for purposes of the Code Section 415(c) definition of compensation. Generally, workers compensation payments are excluded from gross income, provided they are paid under a workers compensation statute, and therefore would not be includible as compensation under Code Section 415(c)(3). We believe this is true regardless of whether the employer is funding the payments directly or has paid for worker's compensation insurance, as in either case the amounts paid would (presumably) be paid pursuant to a worker's compensation statute.

There is a special rule under Code Section 415(c)(3)(C) which provides as follows:

- (C) SPECIAL RULES FOR PERMANENT AND TOTAL DISABILITY. In the case of a participant in any defined contribution plan—
- (i) who is permanently and totally disabled (as defined in section 22(e)(3)),
 - (ii) who is not a highly compensated employee (within the meaning of section 414(q)), and
 - (iii) with respect to whom the employer elects, at such time and in such manner as the Secretary may prescribe, to have this subparagraph apply,

the term "participant's compensation" means the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally

disabled. This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made. If a defined contribution plan provides for the continuation of contributions on behalf of all participants described in clause (i) for a fixed or determinable period, this subparagraph shall be applied without regard to clauses (ii) and (iii).

Treas. Reg. § 1.415-3(d)(1)-(3) provides that the voluntary and mandatory employee contributions (but not picked up contributions) under a defined benefit plan are treated as a separate defined contribution plan maintained by the employer, subject to the limitations on contributions of Code Section 415(c) and Treas. Reg. § 1.415-6. Thus, while Code Section 415(c)(3)(C) specifies its applicability to defined contribution plans, it could be argued that these provisions would be applicable to that portion of a defined benefit plan that is to be treated as a defined contribution plan.

There is very little guidance on the application of Code Section 415(c)(3)(C). Treas. Reg. § 1.415-2(d)(9) is reserved for "special rules for permanent and total disability," but no regulations have yet been issued. IRS Notice 83-10, which provided guidance regarding amendments under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), did provide a limited discussion on Code Section 415(c)(3)(C):

TEFRA amended the definition of compensation to permit a defined contribution plan to include as compensation amounts not actually paid in the case of disabled employees who are not officers, owners, or highly compensated. In such a case, the rate of compensation earned immediately before disability can be imputed for the period of disability. However, any allocations based on this imputed compensation must be nonforfeitable. For example, an employee was compensated at the rate of \$10,000 per year. On July 1, 1981, the employee received a raise that increased his salary to \$20,000 per year. On December 31, 1981, the employee became permanently and totally disabled. Although the employee only received compensation of \$15,000 for 1981, in computing the employee's rate of pay for 1982 the employee is deemed to have compensation at the rate of \$20,000 per year.

The Small Business Job Protection Act of 1996 ("SBJPA") added the last sentence of Code Section 415(c)(3)(C) in order to extend its provisions to highly compensated employees, as explained by the Conference Report on the SBJPA:

Present law

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

House bill

The House bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for continuation of contributions on behalf of all participants who are permanently and totally disabled.

The Conference Report on HR 3448 (August 1, 1996) (emphasis added).

This special rule provides that in the case of an individual with a total and permanent disability, Code Section 415(c) compensation would be deemed to be compensation at the rate the employee was being paid prior to the disability. This then leads to the question of how this provision is applied. It is not clear whether Code Section 415(c)(3)(C) is really designed solely to provide an avenue for an employer to continue to make contributions to a defined contribution plan by imputing to a disabled employee the income that he earned prior to becoming disabled, or instead is definitional for 415 compensation purposes, thereby creating a base for applying the 415(c) limit.

In SDCERS' case, the City has industrial leave paid under the active payroll, with the possibility the person will go to a different payroll (i.e., workers compensation). This may require that a person in this situation be moved to an exception management process.

C. SERVICE PURCHASES

One of our primary areas of concern with regard to 415(c) testing is with respect to service purchases. A voluntary employee after-tax contribution is subject to 415(c) testing unless the more advantageous provisions of Code Section 415(n) apply. As noted in an earlier section of the report, if an employee makes a voluntary contribution for a service purchase, the voluntary contribution may be tested under more generous 415(c) limits or 415(b) limits. The 415(c) limits under 415(n) are as follows:

For purposes of Code Section 415(n) service purchases, only the dollar limit under Code Section 415(c) applies (\$40,000 (adjusted for inflation to \$42,000 for 2005; \$44,000 for 2006)) by treating all permissive service contributions as an annual addition under that limit.

D. ANALYSIS OF ALL CITY PLANS

Code Section 415(g) requires the aggregation of all plans of an employer for 415 testing purposes. Therefore, our other primary area of concern for 415 testing occurs with respect to the other defined contribution plans that are maintained by the City – the 401(k) plan and the SPSP. The City's 457(b) deferred compensation plan is not aggregated with SDCERS.

VI.
APPLICATION OF CODE SECTION 415(c) TO SDCERS
AND RECOMMENDATIONS

A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1010(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further establishes the calendar year as the testing year and permits SDCERS to modify contributions as necessary to ensure compliance with Code Section 415. However, the Board Rules do not contain any provisions relating to Code Section 415 compliance, nor do any other policies or documents of which we are aware.

B. TESTING OF "ANNUAL ADDITIONS"

1. Plan Aggregation

Prior to 1/1/06, SDCERS has not tested annual additions against the Code Section 415(c) limitations. The City administers three defined contribution-type plans: the 401(k), SPSP, and a 457(b) plan. The City tests elective deferrals to the 401(k) and 457(b) plans. The City does not conduct Code Section 415(c) testing for its 401(a) plans (401(k), SPSP, and SDCERS). The other City plans and SDCERS are subject to qualification failure if the 415(c) testing requirement is not satisfied and individuals are contributing in excess of the limitations to the plans in the aggregate. In order to address this qualification issue, SDCERS would have to coordinate with City to test for both the dollar and compensation limits under Code Section 415(c). For a limitation year (the calendar year), SDCERS would have to test after-tax employee contributions to SDCERS against the 415(c) limits by first adding the amount of after-tax SDCERS contribution to the total annual contributions (both employee and employer) made to both the 401(k) and the SPSP plans. The resulting total would be tested against the lesser of the \$40,000 (as adjusted by the IRS annually) dollar limit or the 100% of compensation issue. In order to perform this test, SDCERS must select a definition of compensation that is permitted under the Code (see next section). The pre-tax (picked-up) contributions to SDCERS would not be used in the 415(c) testing.

If the after-tax contribution was made for a purchase of permissive service credit, Code Section 415(n) would apply and permit a higher level of contribution than under Code Section 415(c).

The Airport and Port only offer a 457(b) plan; they do not provide a 401(k) or 401(a) plan. As a result, 415(c) testing for SDCERS purposes would not require aggregation with the Airport and the Port 457(b) plans.

2. Definition of Compensation

We discussed the three safe harbor definitions of compensation with SDCERS staff. Currently, none of the compensation fields provided by the City in Pension Gold represents any of the safe harbor definitions. SDCERS staff and the City have compared W-2 compensation used by the City with "gross compensation" reported as Gross Salary in Pension Gold. SDCERS

staff has determined that the compensation numbers that are currently provided to SDCERS by the plan sponsors do not comport with any of the three safe harbor definitions. Therefore, for future testing purposes, it was determined that SDCERS would ask the plan sponsors to provide the Medicare wages amount from the W-2 system as a reasonable proxy for the safe harbor that starts with taxable wages and then restores elective deferrals.

Finally, please note that all plans which must be aggregated for purposes of 415(c) testing must use the same definition of compensation for those purposes. Therefore, if the plan sponsors are using a different definition of compensation for purposes of their testing, SDCERS must collaborate with them to arrive at a consistent approach.

C. CONCLUSIONS REGARDING RETROSPECTIVE 415(c) TESTING

Given the 415(b) testing approach described in earlier sections of this Report, SDCERS is proposing not to do retrospective 415(c) testing. This should be a reasonable approach considering the following factors:

- Since 1987, all mandatory employer contributions have been picked-up and thus would be subject to 415(b) testing.
- Since 1997, all service purchases made with after-tax employer dollars are subject to either modified 415(c) testing or modified 415(b) testing. SDCERS has elected 415(b) testing.
- Service purchases permitted as of August 5, 1997 are grandfathered and thus are not subject to 415(c) testing.
- For retrospective 415(b) testing, SDCERS is not backing out any after-tax employee contributions.
- Service purchases made via rollover and plan-to-plan transfer from the DC plans are not subject to 415(c) testing.
- Service purchases made by plan-to-plan transfers from the 457(b) plan are subject to regular 415(b) testing.

D. CONCLUSIONS REGARDING PROSPECTIVE 415(c) TESTING

Given the practical problems associated with 415(c) testing, SDCERS has determined to take the following prospective approach starting January 1, 2007. For the 2006 calendar year, a self-correction approach will be followed.

1. Definition of Tested Group

The tested group will consist of all employees making after-tax contributions on and after January 1, 2007.

2. Testing of Service Purchases Made with After-Tax Employee Contributions

All service purchases made with after-tax employee contributions will be tested under the modified 415(b) testing under 415(n) if the service being purchased is permissive service, including qualified and nonqualified service, in accordance with the chart above. This means the benefit attributable to these contributions will not be tested under 415(c).

3. Testing of Other After-Tax Employee Contributions

Any other after-tax employee contributions received would be tested at the time of receipt on an "exception basis." This means that prior to actually accepting the employee after-tax contributions, SDCERS would contact the City and inform it of the after-tax contributions and run the 415(c) test. If the contributions "passed," they would be accepted. If the contributions failed, they would not be accepted. At the end of the calendar year, those individuals from whom after-tax contributions were accepted would be retested.

4. USERRA Testing

In the case of USERRA contributions, the 415(c) limits that would be examined would be the limits in place with respect to the covered service – not necessarily the year of the payment.

5. Compensation Definition

SDCERS will request the plan sponsors provide the Medicare wages amount from the W-2 system and use that to test.

6. Testing Protocol

The testing protocol for this is set forth in Exhibit D.

7. Priority

One issue raised in this context is that of "priority." That is, it is important that a clear priority be established among the different plans as to what will be reduced first, second, etc. in the event that annual additions exceed the Code Section 415(c) limitation. This priority list should include not just the different San Diego defined contribution plans, but also the different types of contributions possible to each of those plans.

- First, attempt the correction through the 401(k) program. The amount of excess contributions would be distributed to the member.
- If the amount of 401(k) contributions for the year is not enough for the correction, then the next plan to consider would be SPSP. However, in order to preserve the plan's status as the Social Security replacement plan, the amount of contributions available to be refunded would be limited to the voluntary contributions.

- If the amount in the SPSP available for refund was insufficient to make the correction, then the correction would have to be made from SDCERS. This could affect the member's service purchase.

E. TESTING OF SERVICE PURCHASES – BY SOURCE

1. SDCERS Provisions

SDMC § 24.1310(a) provides that in order to purchase Creditable Service a member must pay an amount, including interest, determined by the Board before the effective date of retirement. This section goes on to provide as follows:

- (b) Subject to any limitations imposed by the Internal Revenue Code, such payments under section 24.1310(a) may be made by lump sum, installment payments, direct transfer to the Retirement System from any defined contribution plan maintained by the City of San Diego, or in such manner and at such time as the Board may by rule prescribe. Any sums paid by a Member under section 24.1310 are considered to be and administered as Member contributions.

SDMC § 24.1310(b). The Board has adopted rules under this section, which the Board has recently amended to read as follows:

Rule 10.50 Methods of Payment.

- (a) Subject to any limitations or conditions imposed by applicable tax laws and regulations, a member may pay for service credit by:
 - (1) lump sum,
 - (2) installment payments through payroll deduction,
 - (3) direct transfer to the Retirement System from any tax qualified defined contribution plan maintained by the City, Airport Authority or Unified Port District,
 - (4) rollover or direct transfer of funds from an eligible retirement plan,
 - (5) direct in-service transfer from an IRC 457(b) compensation plan or an IRC 403(b) plan, subject to Board Rule 10.60 (subject to prior approval by the IRS); or
 - (6) any other source allowable under federal law.
- (b) The System will treat all amounts paid by members under this Division as member contributions.

- (c) A member must complete all payments to purchase service credit before his or her effective date of retirement, entry into DROP, or termination of employment (in the case of a deferred retirement).
- (d) If a member elects to make installment payments:
 - (1) the member must agree to an installment contract with a payment plan that includes the purchase cost plus installment interest,
 - (2) the payments must be made through payroll deduction,
 - (3) the payments must be at least \$20 per pay period,
 - (4) the System will charge installment interest to the member's individual account using the actuarial assumed interest rate in effect at the time the installment contract is executed, and
 - (5) if making pre-tax payments, the member must complete the installment contract before he or she first becomes eligible to service retire, unless the member acknowledges in writing the negative consequences of failing to do so. (See form SDCERS uses for this. See Exhibit L.)

Board Rule 10.50.

The Board has adopted Rule 10.60 to read as follows:

Rule 10.60 In-Service Transfer of Funds from a 457 Defined Compensation Plan to Purchase Service Credit.

- (a) Purchase of Service Credit under General Five-Year Provision (Board Rule 10.10): Before assets may be transferred to SDCERS in-service from a 457 plan to purchase service under Board Rule 10.10 (general five-year purchase), the member must complete and sign a certification of corresponding service. Corresponding service may be any compensated private or public sector service or self-employment, as long as the service has not been credit under any SDCERS plan (City, Airport Authority or Unified Port District). The amount of corresponding service must be equal to or greater than the amount of service credit the member is purchasing. This subsection will become effective upon IRS approval of the certification procedure.
- (b) Purchase of "Service-Connected" Service Credit. A member may purchase service-connected service credit under Board Rule 10.00 by an in-service plan-to-plan transfer from a 457(b) plan. No certification of corresponding service is required.

With this new Rule 10.60 in place, subject to IRS prior approval, transfers from the 457 plan will be accepted for service purchases as described in (a) and (b). See PLR 200550042.

The Board Rules also provides for the terms of installment contracts in Board Rule 10.70. Based upon these rules, it is clear that SDCERS has attempted to avail itself of all methods of service purchases.

2. Compliance Testing Chart

The following chart shows how the available sources of voluntary employee contributions for service purchases should be tested under either Code Section 415(c) or 415(n). (Refer to the earlier chart for a categorization of service purchases as permissive service and as qualified and non-qualified service.)

Voluntary Employee Contributions for Service Purchases	415(c) Testing or 415(n) Testing
In-service transfers from DC Plans (401(k), SPSP)	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum after-tax employee contributions and installment contracts for after-tax contributions if for non-permissive service or for nonqualified permissive service credit in excess of limits	415(c) limits apply (lesser of \$40,000 (adjusted) or 100% compensation in the year of purchase). These will be tested on an exception basis.
Lump sum after-tax employee contributions and installment contracts for after-tax contributions if for permissive service	415(n) limits apply. Therefore, purchase will be tested under modified 415(b) limits.
Picked-up employee contributions for installment contracts Note: A favorable IRS private letter ruling is the mechanism for obtaining approval for a pick-up of employee contributions for a service purchase.	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum rollovers from eligible plans (401(a), 457(b), 403(b), 401(k), 403(a) and IRAs)	415(c) limits (including 415(n) modified limits) do not apply. Rollovers only after separation from service except IRAs.
Repayment of refunded contributions	Under 415(c)(3), 415(c) limits will not apply. 415(b) limits will apply at distribution.
Lump sum transfers from 457(b)/403(b) plans	Limited to permissive service credit and restoration of service. 415(c) limits will not apply. 415(b) limits will apply. <u>See</u> Rule 10.60.

It is our understanding from SDCERS staff that the vast majority of service purchases are made by plan-to-plan transfer from the Employers' plans. However, all of the other mechanisms are used to some extent, including after-tax payments.

3. Leave Conversion Contributions

In addition to service purchases, the Municipal Code also provides for leave conversion to Creditable Service:

- (c) Notwithstanding section 24.1310(a), effective July 1, 2002, represented Members in the San Diego Firefighters Local 145 bargaining unit who have not yet entered DROP may convert the cash equivalent of their Unused Annual Leave accrued after July 1, 2002, to Creditable Service in the Retirement System on a pre-tax basis. The amount of the Creditable Service to be credited in the Retirement System will be the amount the Board determines to be the employer and employee cost of that Creditable Service. Represented Members in the Local 145 bargaining unit are not eligible to exercise any cash-out feature of Annual Leave that they accrue after July 1, 2002, including Annual Leave accrued after July 1, 2002, while in DROP.

SDMC § 24.1310(c). This provision provides for a pre-tax conversion of unused annual leave in order to buy service in SDCERS.⁷ If these amounts were converted on a pre-tax basis, the benefit attributable to these conversion amounts would be tested under 415(b). Please note: collection of those converted contributions is covered in our Exclusive Benefit Report.

F. TESTING OF USERRA SERVICE PURCHASES

SDMC § 24.1309 addresses purchase of retirement credit for service in the armed forces. The provision specifies that for purchases made pursuant to a leave due to military service, the payment is treated as an annual addition for the calendar year to which it relates. In order to provide appropriate treatment of USERRA service purchases, SDCERS will need to work with Employers to determine USERRA eligibility. The problem of accurate USERRA reporting may be limited to only a few SDCERS members because most SDCERS members who are called to military service receive differential pay. It is the City's practice to deduct the member's contribution from the differential pay on a picked-up basis. As a result, most SDCERS members retiring from USERRA-covered service to employment do not need to make any contributions for the USERRA leave period.

⁷ It is our understanding that post July 1, 2002, hours can be converted or used to extend DROP or run out with a terminal leave. On the City side, the hours after July 1, 2002 cannot be cashed out. We further understand the value of these annual leave hours is calculated using the hourly rate calculated on the same basis as the pension salary, then converted to dollars, which dollars are then reconverted to additional time. An example presented was where 500 hours equated to \$30,000, which (for that individual) would purchase 1.8472 additional years. The individual can choose how much to convert.

VII.
VOLUNTARY CORRECTION PROGRAM ("VCP") FILING

A. GENERAL APPROACH

As problems were discovered, we worked with SDCERS, Cheiron, and Linea to develop a correction mechanism. As we have previously discussed, the Employee Plans Compliance Resolution System ("EPCRS"), Revenue Procedure 2003-44, provides for a Voluntary Correction Program ("VCP") under which the IRS approves a plan qualification correction through the issuance of a Compliance Statement. The VCP program is governed by a variety of correction principals. One of the key requirements is "full correction":

Generally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years.

Rev. Proc. 2003-44, Section 6.01. However, as noted in the Conclusion Sections above, SDCERS wishes to make a case for a less than full correction based upon the unique facts of the situation. The testing protocols being proposed are all outlined in Sections IV and VI above.

B. TIMETABLE

The VCP would cover the retrospective analysis that covers retirees from 1995 through the end of 2005. SDCERS would then apply self-correction for 2006. Prospective testing would begin in 2007.

CIRCULAR 230 DISCLOSURE

Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

Appendix A

Overview of Code Section 415 Proposed Regulations

DEFINED BENEFIT PLANS

- **Multiple annuity starting dates.** The Proposed Regulations provide new rules for determining the annual benefit under a defined benefit plan when there has been more than one annuity starting date (i.e., where the application of the Code Section 415(b) limit must take into account prior distributions as well as currently commencing distributions). Prop. Reg. § 1.415(b)-2. This would occur when a participant has received one or more distributions in limitation years prior to an increase in the accrued benefit occurring during the current limitation year or prior to the annuity starting date for a distribution that commences during the current limitation year. These rules may also apply when a benefit payment is increased as a result of plan terms applying a cost-of-living adjustment ("COLA") pursuant to an adjustment of the Code Section 415(b) dollar limit, unless the plan provides for application of a safe harbor methodology set forth in the Proposed Regulations for determining the adjusted amount of the benefit (see discussion below under cost-of-living adjustments).

In the case of multiple annuity starting dates, the annual benefit subject to Code Section 415(b) testing is equal to the sum of the annual straight life equivalent annuity attributable to the following:

1. the accrued benefit that has not commenced;
2. the annual benefit determined for any distribution with an annuity starting date that occurs within the current limitation year and on or before the current determination date;
3. the annual benefit determined for any remaining amounts payable under a distribution with an annuity starting date that commenced in a prior year; and
4. the annual benefit attributable to prior distributions.

Prop. Reg. § 1.415(b)-2(a)(3)(i).

The annual benefit attributable to prior distributions is determined by adjusting the amounts of prior distributions to an actuarially equivalent straight life annuity commencing at the current determination date. The Proposed Regulations apply rules that are analogous to the rules for adjusting other benefits to determine the amount of the actuarially equivalent straight life annuity for purposes of determining the annual benefit attributable to prior distributions. Prop. Reg. § 1.415(b)-2(a)(3)(ii), (b).

A prior distribution that has been entirely repaid to the plan (with interest) does not give rise to an annual benefit attributable to prior distributions. Prop. Reg. § 1.415(b)-2(a)(3)(iv).

In the case of a new election modifying multiple annuity payments that have already commenced, the payments made before the change plus the modified payments must satisfy the Code Section 415(b) limit in effect on the original annuity starting date, based on the assumptions applicable at that time. However, payment adjustments that reflect cost-of-living increases under Code Section 415(d) are ignored for this purpose.

- **Note:** The specific rules on the application of testing of multiple annuity starting dates are very complex. Ice Miller's comment letter focused on this area as a primary cause for concern and urges the Service to take a simpler approach to testing in this area. We believe the multiple annuity starting date proposed rules could impact a variety of common governmental plan features – ad hoc COLAs, 13th checks, DROPs, PLSOs, and plan amendments. We also think it also provides a difficult interaction with Code Section 401(a)(9) compliance.

- **Cost-of-living adjustments.**

- **IRS Limit Adjustments.** The Proposed Regulations provide rules regarding application of the cost-of-living adjustments to the Code Section 415 limits. Prop. Reg. § 1.415(d)-1. The Regulations specify the circumstances under which an adjusted limit is permitted to be applied to participants who have previously commenced receiving benefits under a defined benefit plan. The adjusted limit would be applicable to current employees who are participants in a defined benefit plan and to former employees who have retired or otherwise terminated service and have a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive benefits. A plan may provide that the annual increase applies for a participant who has previously commenced receiving benefits only to the extent that benefits have not been paid, and a plan must specifically so provide in order for the increase to be effective. Prop. Reg. § 1.415(a)-1(d)(3)(v)(C).

The Proposed Regulations provide a safe harbor under which the annual benefit will satisfy the limitations of Code Section 415(b) for the current limitation year following an adjustment to benefit payments that is made to reflect the IRS cost-of-living adjustment made under Code Section 415(d). If such adjustments are made in accordance with this safe harbor, the multiple annuity starting date rules will not apply with respect to such adjustment.

An adjustment to a benefit for a COLA increase under Code Section 415(d) will be treated as being made under the safe harbor if (1) the participant has received one or more distributions that satisfy the requirements of Code Section 415(b) before the date the increase to the applicable limit is effective; (2) the adjusted distribution is solely as a result of an increase in the Code Section 415(d) limits; and (3) the amount payable to the employee for the limitation year and subsequent limitation years is not greater than the amounts that would otherwise be payable without regard to the adjustment, multiplied by a fraction, the numerator of which is the limitation under Code Section 415(b) in effect for the distribution following the Code Section 415(d) increase, and the denominator of which is such limitation

under Code Section 415(b) in effect for the distribution immediately before the increase. Prop. Reg. § 1.415(d)-1(a)(5).

- **Plan Benefits with Fixed COLAs.** Last year the IRS issued PLR 200452039, which provided that a plan benefit with an automatic COLA had to take into account the value of the COLA when testing the benefit under the Code Section 415(b) limit. Under the Proposed Regulations, there is an example under which the plan had to reduce the benefit limit to recognize the value of any automatic, fixed COLAs provided under the plan. Prop. Reg. § 1.415(b)-1(c)(5), Example 6.
- **Benefit tested under 415(b).** The Proposed Regulations prohibit both the payment and accrual of a benefit in excess of the Code Section 415(b) limits. Prop. Reg. § 1.415(b)-1(a)(1) (3). In the past, this Code Section has generally been interpreted for governmental plans as requiring that benefits paid, not just accrued, must meet the 415(b) limit.
 - **Note:** Our comment letter to the Service raises the problems with this issue, including an overarching concern with the focus of the Proposed Regulations on the accrual concept versus the benefit payment concept, noting the inherent difficulties this would present for governmental plans. We really think this is the "heart" of the problem with the Proposed Regulations. Without a different reference point (at least for governmental plans), compliance will be very problematic.
- **Dollar limit applicable to early or late retirement.** Code Section 415(b)(2)(C) provides that the dollar limit must be actuarially reduced when benefits begin before age 62. The Proposed Regulations generally use the plan's determinations for actuarial equivalence of early retirement benefits, but override them when the use of the specified statutory assumptions results in a lower limit. Prop. Reg. § 1.415(b)-1(d).

If the benefit is not forfeited at the member's death, there is no adjustment to the dollar limit with respect to mortality to reflect the probability of the member's death between the annuity starting date and age 62 (which results in a higher dollar limit than if mortality were considered). The Proposed Regulations allow a plan to treat a benefit as not being forfeited if the plan does not charge members for providing a qualified pre-retirement survivor annuity, but only if the plan applies this treatment for adjustments before age 62 and after age 65. Prop. Reg. § 1.415(b)-1(d)(2).

Pursuant to Code Section 415(b)(2)(I), the dollar limit is not adjusted for commencement before age 62 for a distribution from a governmental plan on account of the participant becoming disabled by reason of personal injuries or sickness, or as a result of the death of the participant. Prop. Reg. § 1.415(b)-1(d)(4). Similarly, the less than ten years of participation reduction does not apply to such benefits. Prop. Reg. § 1.415(b)-1(g)(3).

The Proposed Regulations similarly provide for the dollar limit to be actuarially increased for benefits that begin after age 65. However, if the plan does not actuarially increase benefits in the case of later retirement age, the dollar limit adjustment is not permitted.

Prop. Reg. §§ 1.415(a)-1(d)(3)(v)(C); 1.415(b)-1(e). A National Council on Teacher Retirement representative testified on this point at the August 17 hearing, urging the Service to reconsider this approach.

- **Conversion of benefits to straight life annuity.** The Proposed Regulations provide rules under which a retirement benefit payable in any form other than a straight life annuity (or qualified joint and survivor annuity ("QJSA")) is converted to the straight life annuity that is actuarially equivalent to that other form to determine the annual benefit used to show compliance with Code Section 415 for that form of distribution. The Proposed Regulations reflect statutory changes that specify the actuarial assumptions to be used for these equivalency calculations. Prop. Reg. § 1.415(b)-1(c).

For a form of benefit that is not subject to the minimum present value rules of Code Section 417(e) (which includes any governmental plan benefits), the straight life annuity payable under the plan at the member's current age (not the straight life actuarial equivalent of the selected benefit form using the plan's actuarial assumptions) is compared to the straight life annuity that is the actuarial equivalent of the optional form of benefit, determined using specified statutory assumptions, and the larger of the two straight life annuities is used as the annual benefit subject to 415 testing. Prop. Reg. § 1.415(b)-1(c)(2).

➤ **Note:** Ice Miller's comment letter addresses the issue of the appropriate actuarial assumptions that should be used for this conversion.

- **Benefit forms for which no adjustment is required.** The survivor portion of a benefit that is a QJSA is not taken into account in determining the annual benefit subject to 415(b) testing. The Proposed Regulations provide that this exception will apply to any portion of a benefit that is paid as a QJSA, even if another portion of the benefit is paid in some other form (for example, a partial lump sum). Prop. Reg. § 1.415(b)-1(c)(4)(i)(A), (ii)(B).

Further, ancillary benefits not directly related to retirement benefits are not taken into account for purposes of Code Section 415(b) testing. Prop. Reg. § 1.415(b)-1(c)(4)(i)(B).

- **Exclusion of annual benefit attributable to mandatory after-tax employee contributions.** The Proposed Regulations retain the rules under the existing regulations that the annual benefit does not include the annual benefit attributable to mandatory employee contributions (which are not picked-up). Prop. Reg. § 1.415(b)-1(b)(1)(ii).

The Regulations provide that the annual benefit attributable to mandatory employee contributions is determined using the factors described in Code Section 411(c)(2)(B) and (C) and the regulations thereunder, regardless of whether Code Section 411 applies to the plan (which such Section does not apply to a governmental plan). Prop. Reg. § 1.415(b)-1(b)(2)(iii). Mandatory employee contributions (which are not picked-up) are treated as annual additions to a defined contribution plan for purposes of Code Section 415(c). Prop. Reg. § 1.415(c)-1(a)(2)(ii)(B) and (b)(3). Picked-up employee contributions are

treated as employer contributions to a defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(2)(ii)(A).

- **Note:** In our comment letter to the Service, we have raised our concerns with the difficulties in applying the Code Section 411 methodology in the governmental plan context.

The Proposed Regulations provide that, if voluntary employee contributions are made to a plan, the portion of the plan to which such contributions are made is treated as a defined contribution plan under Code Section 414(k), not a defined benefit plan, and is not taken into account in determining the annual benefit under the portion of the plan that is a defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(2)(iv).

The Proposed Regulations would clarify that picked-up contributions, loan repayments, the repayment of any amount previously distributed, and the repayment of withdrawn employee contributions, would not be treated as employee contributions. Prop. Reg. § 1.415(b)-1(b)(2)(ii).

The Proposed Regulations also provide that, in determining the amount of the annual benefit that is excluded from testing because it is funded by employee contributions, member repayments of withdrawn contributions, even if paid after-tax (and thus counted as basis) would not be treated as employee contributions.

- **Note:** This treatment does not seem consistent with Code Section 415(k)(3), which provides that repayments of previously withdrawn contributions, plus interest, are not subject to the Code Section 415 limits. Ice Miller's comment letter has raised this issue with the Service.
- **Exclusion of annual benefit attributable to rollovers.** The Proposed Regulations clarify that the annual benefit subject to Code Section 415(b) testing does not include the annual benefit attributable to rollover contributions made to a defined benefit plan (*i.e.*, rollover contributions that are not maintained in a separate account that is treated as a separate defined contribution plan under Code Section 414(k)). Prop. Reg. § 1.415(b)-1(b)(1)(ii). In this situation, the annual benefit attributable to the rollover contributions is determined by applying the rules of Code Section 411(c), treating the rollover contributions as employee contributions, regardless of whether Section 411 applies to the plan. The Proposed Regulations specify that if a plan uses more favorable factors than those specified in Code Section 411(c) to determine the amount of annuity payments arising from a rollover contribution, the annual benefit under the plan would reflect the excess of those annuity payments over the amount that would be specified in Code Section 411(c). Prop. Reg. § 1.415(b)-1(b)(2)(v).
- **Note:** This is an area upon which we have commented to the Service, arguing that the Code Section 411 rules, which are not generally applicable to governmental plans, should not be used in these circumstances; rather, we have proposed that public plans be permitted to use the plan actuarial factors in this

circumstance. We have also asked the Service to provide an example of a defined benefit plan to a defined benefit plan rollover.

- **Treatment of benefits transferred among plans.** Under the current Code Section 415 Regulations, if a transfer is from one qualified plan to another qualified plan, the annual benefit attributable to the transferred assets is not taken into account by the transferee plan. Treas. Reg. § 1.415-3(b)(1)(iv). Further, a transfer from one qualified plan to another qualified plan is not an annual addition in the year of the transfer. Treas. Reg. § 1.415-6(b)(2)(iv).

The Proposed Regulations attempt to provide further detail on the treatment of transfers between qualified plans, presumably to address concerns by the Service that funds are being transferred between plans without ever ultimately being tested in some fashion under Code Section 415. The Proposed Regulations view transfers on a defined benefit plan to defined benefit plan and defined contribution plan to defined contribution plan basis. The Proposed Regulations would modify the rules of the existing Final Regulations for determining the amount of transferred benefits that are excluded from the annual benefit under a defined benefit plan in the event of a transfer from another defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(3).

In the case of transfers between defined benefit plans subject to the plan aggregation rules (i.e., the annual benefit under both plans must be combined for purposes of Code Section 415 testing), the transferred benefits are included in determining the annual benefit under the plan receiving the transfer (the transferee plan) and are disregarded in determining the annual benefit under the transferring plan (the transferor plan). Thus, under each plan, the annual benefit is determined taking into account the actual benefits provided under that plan after the transfer. Prop. Reg. § 1.415(b)-1(b)(3)(A).

In the case of transfers between non-aggregated defined benefit plans, the benefits associated with the transferred liabilities (other than surplus assets) are treated by the transferor plan as a single sum distribution (which presumably is tested under the Code Section 415(b) limit). Although such a transfer is treated as a distribution in computing the annual benefit under the transferor plan, no corresponding adjustment to the annual benefit under the transferee plan is made to reflect the fact that some of the benefits provided under the transferee plan are attributable to the transfer. Thus, the actual benefit provided under the transferee plan is used to test the annual benefit under the transferee plan, even though the transferred amount is included as a distribution in determining the annual benefit under the transferor plan. Prop. Reg. § 1.415(b)-1(b)(3)(B).

In the case of transfers between defined contributions plans, the transfer is not treated as an annual addition.

Thus, transfers between defined benefit and defined contribution plans are not specifically addressed under the Proposed Regulations; in particular, the difficult issue is a transfer from a defined benefit to a defined contribution plan. Hopefully, the Final Regulations will provide some clarity to this issue.

- **Application of \$10,000 exception.** The benefits payable to a participant will satisfy Code Section 415(b) if the benefits payable to that participant under the plan and all other defined benefit plans of the participant do not exceed \$10,000 for the plan year or for any prior plan year, and the employer has not at any time maintained a defined contribution plan in which the participant participated. Thus, for example, a distribution for a limitation year that exceeds \$10,000 will not fall in this exception, even if it is a single-sum distribution that is the actuarial equivalent of an accrued benefit with annual payments that are less than \$10,000. Prop. Reg. § 1.415(b)-1(f).
- **Less than 10 years of participation.** The dollar limit is reduced pro-rata if a participant has fewer than 10 years of participation in the plan. This reduction does not apply to a distribution of survivor or disability benefits from a governmental plan. Prop. Reg. § 1.415(b)-1(g).
- **QDRO payments.** For purposes of Code Section 415, benefits provided to an alternate payee under a QDRO are treated as if provided to the member. Prop. Reg. § 1.415(a)-1(f)(5).

DEFINED CONTRIBUTION PLANS

- **Timing of contributions.** The Proposed Regulations would modify the deadline for making employer contributions to a plan that are credited to a participant's account for a limitation year for purposes of Code Section 415(c). Under the Proposed Regulations, the deadline for a tax-exempt employer to make a contribution to the plan that is credited to a participant's account for a limitation year for purposes of Code Section 415(c) is the 15th day of the tenth calendar month following the close of the taxable year with or within which the particular limitation year ends. Prop. Reg. § 1.415(c)-1(b)(6)(B).
 - **Note:** This is an extension from the earlier deadline now applicable under the existing regulations (the 15th day of the sixth calendar month following the close of the taxable year with or within which the particular limitation year ends).

As under the current Regulations, employee contributions may not be included in a limitation year unless they are actually made to the plan within 30 days after the close of the limitation year. Prop. Reg. § 1.415(c)-1(b)(6)(C).

The Proposed Regulations also confirm that employer make-up contributions made pursuant to USERRA, resulting from qualified military service, are not treated as an annual addition for the year in which the contribution is made, but are treated as an annual addition for the year to which the contribution relates. Prop. Reg. § 1.415(c)-1(b)(6)(ii)(D).

- **Definition of "Compensation".** The Proposed Regulations primarily reflect several statutory changes that were made to Code Section 415(c)(3) since the issuance of the existing Final Regulations. Among these changes are the inclusion in compensation of certain deemed amounts for disabled participants and nontaxable elective amounts for deferrals under Code Sections 401(k), 403(b), and 457, cafeteria plan elections under

Section 125, and qualified transportation fringe benefit elections under Code Section 132(f)(4). Prop. Reg. § 1.415(c)-2.

The Proposed Regulations also permit a plan to use a safe harbor definition of compensation, including Form W-2 wages or wages subject to income tax withholding. Prop. Reg. § 1.415(c)-2(d).

The Proposed Regulations also provide that the definition of compensation is subject to the Code Section 401(a)(17) limits, which is a departure from the generally accepted understanding of this rule. However, because governmental plans are not subject to the 100% of compensation limit under Code Section 415(b), this issue has little practical significance for public plans.

- **Compensation after severance from employment.** The Proposed Regulations provide specific rules regarding when amounts received following a severance from employment may be included as compensation for purposes of Code Section 415. Unlike the other provisions of the Proposed Regulations (which may not be relied upon until the Final Regulations are issued), these changes may be considered effective immediately for limitation years beginning on or after January 1, 2005. Prop. Reg. § 1.415(c)-2(e).

Generally, the Proposed Regulations provide that amounts received after severance from employment are not considered compensation under Code Section 415, except for the following:

- If made within 2½ months after a severance from employment, payments (such as regular compensation, overtime, bonuses, etc.) that would have been payable if employment had not terminated, and payments with regard to accumulated leave time that would have been available for use if employment had not terminated, may be included as compensation under Code Section 415. This exception would not include pure severance pay.

Military differential pay, i.e., pay from an employer to an employee who is in qualified military service, may be included as compensation for purposes of Code Section 415.

- **Note:** It is not clear from the Proposed Regulations how payments of regular salary which are made more than 2½ months after severance from employment would be treated. Ice Miller's comment letter asks the Service to clarify this issue.

- **Annual additions subject to Code Section 415(c).** The Proposed Regulations clarify the definition of "annual additions" which are subject to Code Section 415(c) testing, which include employer contributions, employee contributions, and forfeitures. Prop. Reg. § 1.415(c)-1(b). Additionally, contributions to individual medical accounts that are part of a pension plan under Code Section 401(h) are treated as annual additions to a defined contribution plan (but such contributions are only subject to the dollar limit of Code § 415(c)). Prop. Reg. § 1.415(c)-1(a)(2)(ii)(C), (e). Annual additions do not

include rollovers, repayments under Code Section 415(k)(3), or transfers from another defined contribution plan. Prop. Reg. § 1.415(c)-1(b)(1)(iii). (b)(3).

- **Limitation year.** The Proposed Regulations set forth rules regarding the limitation year that generally correspond to the rules under the existing Regulations, and also provide specific guidelines with respect to overlapping limitation years for aggregated plans. Prop. Reg. § 1.415(j)-1.

Where defined contribution plans with different limitation years are aggregated, Code Section 415(c) must be applied with respect to each limitation year of each such plan. For each such limitation year, Code Section 415(c) is applied to annual additions that are made for that time period with respect to the participant under all aggregated plans. Similarly, where defined benefit plans with different limitation years are aggregated, the rules of Code Section 415(b) must be applied with respect to each limitation year of each such plan. Thus, the dollar limit of Code Section 415(b)(1)(A) applicable for the limitation year for each plan must be applied to annual benefits under all aggregated plans to determine whether the plan satisfies the requirements of Code Section 415(b).

RULES OF GENERAL APPLICABILITY

- **Combining and aggregating plans.** Under Code Section 415(f) and the Proposed Regulations, all defined benefit plans of an employer are treated as one defined benefit plan, and all defined contribution plans of an employer are treated as one defined contribution plan. Prop. Reg. § 1.415(f)-1.
- **No specific guidance under Sections 415(n) or 415(m).** The IRS did not issue guidance with respect to the permissive service credit rules under Code Section 415(n) or qualified excess benefit arrangements ("QEBAs") under Code Section 415(m), but did ask for comments regarding the need for guidance on these provisions. In our comments to the IRS we did not request guidance on these statutory sections but did offer our observations on a few key issues in the event that the IRS does issue guidance.

INDEX OF EXHIBITS

- Exhibit A: Cheiron Report on Retrospective 415(b) Testing
- Exhibit B: Cheiron Report on Prospective 415(b) Testing
- Exhibit C: Linea Solutions 415(b) Operational Process Document
- Exhibit D: Linea Solutions 415(c) Operational Process Documents and Charts
- Exhibit E: Cheiron 415(b) Testing Assumptions
- Exhibit F: Cheiron Determination of Accumulated Payments from SDCERS Over 415 Limits
- Exhibit G: Cheiron Sample Screen from Prospective Testing
- Exhibit H: Cheiron General Employee Limits
- Exhibit I: Cheiron Uniform/Safety Employee Limits
- Exhibit J: Cheiron Sample Description of Testing Data
- Exhibit K: Cheiron Retired 415 Test Results
- Exhibit L: Service Purchase Withholding Form

Exhibit A: Cheiron Procedures on Retrospective 415(b) Testing

San Diego City Employees Retirement System

Retroactive Testing of Internal Revenue Code Section 415(b) Maximum Allowable Defined Benefits Payable from a Qualified Trust

The following is a narrative summary of the procedure performed by Cheiron, Inc, the San Diego City Employees Retirement System's (SDCERS) Actuary in coordination with Ice Miller, LLP and SDCERS staff in performing retroactive testing of Internal Revenue Code (Code) Section 415(b) testing of defined benefits. In performing this testing Cheiron relied on the data provided by SDCERS and interpretations and guidance of Ice Miller LLP.

Procedure to test current retirees

The first step was to identify the testing population. We started with the database provided in performing our actuarial valuation of SDCERS as of July 1, 2005. These were the steps in defining the test population:

- SDCERS provided Cheiron with 5,530 retiree records. Each record included social security number, first, middle, and last name, benefit type, effective date, termination date, annuity, pension, cola and base amount
- We then received the DROP account balances database, which contained 1,083 records
- We match these records with the data provided for the June 30, 2005 actuarial valuation and reconciled databases
- It was determined that for compliance submission we should look at all retirees since January 1, 1995 for testing purposes in accordance with the criteria and recommendations outlined in Ice Millers report. On this basis the testing population was defined to contain 2,067 participants in pay status.

Start:	5,531
Total after removing retirement effective prior 1/1/1995:	(2,974)
Total receiving disability benefits	<u>(490)</u>
Net testing population	2,067

Of the 2,067 testing records:

- 2,041 matched records from the June 30, 2005 valuation data including;
 - 1,906 as retirees

- 48 as beneficiaries
 - 28 deferred vested
 - 59 actives
- There were 26 records that did not match the June 30, 2005 valuation data and were determined to reflect deceased or suspended participants, not subject to testing.
 - We subsequently reviewed the disabled retirees and reviewed the level of benefits for any disabled retirees whos' current age was beyond normal retirement and determined their benefits were not in excess of the appropriate 415(b) limits.
 - For testing purposes there were 106 participants missing service credit data in our database. For those with benefits equal or greater then 50% of the 415(b) limit we requested additional information to ensure they had 10 or more years of service to ensure the minimum annual accrual limits were complied with.

With the testing population defined, we then proceeded to define the total aggregate benefit payable at retirement from SDCERS. This step included:

- Extracted from the **database** date of birth, total service credits, plan ID (general employee versus public safety), benefit type, standard benefit, cost of living adjustment (CPI with 2% cap, 13th check), benefit granted through subsequent litigation or grants [Corbett and Andrecht] , payment option, DROP account and form of DROP payment
- For the **DROP accounts** if benefits were payable as a lump sum at retirement we converted them to annuities using the appropriate conversion assumptions at retirement (a 5% interest rate and appropriate mortality table based on the date of actual retirement). If the DROP account was payable over time, we projected the payouts at the current crediting rate of 8% and discounted back the payments at the testing rate (5%) using the net result to conver to annuities
- For the **COLA benefits** it was determined the CPI COLA subject to the 2% cap was a safe harbor adjustment that would track with or behind the 415 limitation indexation. The 13th check while contingent on excess earnings has been fully granted in all but two years and was assumed to be a permanent benefit and subject to testing. as if permanent

With each of the component benefits identified we determined a potential failure group by making some general assumptions to identify potential test failures (participants in pay status receiving in excess of the appropriate 415 limit). This group would then be resubmitted to SDCERS for verification of each of the data elements. The intent was to err on the side of a larger then needed population to capture any potential values before the case by case review proceeded. We added the following steps:

- While we had optional forms of benefit to convert to standard life annuities or qualified survivor benefits, we did not have information as to whether the beneficiary under the joint and survivor options was a qualified spouse, to be

most inclusive we therefore assumed that all survivors benefits were non spouse beneficiaries and increased the base benefit to be 20% of the reported value to simulate the actuarial adjustment that might apply.

- We determined the total annual annuity for each retiree by adding the pension adjusted for form of payment, the 13th check benefits, the adjusted and annuitized DROP benefits and the Corbett benefits together (the Andrecht benefits were included in the pensions provided by SDCERS as their payment of this benefit was not contingent on excess earnings).
- We then tested all participants against the 415 limitation in effect at time of retirement, based on appropriate limits adjusted for age at benefit commencement, employment classification (general versus public safety). Year of retirement and defined normal retirement age.
- By taking a ratio of the sum of the benefit pieces to the appropriate 415 limit we identified all participants with a ratio of 90% or greater and defined this group as our potential failures.

From this process we identified 89 participants in pay status and submitted the list to SDCERS to go through each file and confirm the data used as well as identify additional information to use in the testing.

Up to this point there were a set of assumptions used in the testing that were jointly decided upon with Ice Miller and SDCERS which included:

- Not to account and offset for any post tax employee contributions – these amounts could either offset the defined benefit tested and be subject to Section 415(c) testing or be ignore here
- Not to adjust for service purchases – It was agreed to include test benefits without offset, as was unclear if the data could be obtained to identify such amounts were pre or post tax dollars used, as well as securing which service was eligible for offset as qualified permissive service

Along with confirmation of the data used for this initial testing, we requesting information that would affect the final test including whether the benefits reflect:

- Offset for benefits purchased from qualified rollovers amounts
- Eligibility for public safety limitations by virtue of having 15 or more years of service as a public safety employee
- Aggregation of benefits from a qualified domestic relations order in effect at the time of retirement
- Confirmation for those participants with joint and survivor options in effect as to whether the beneficiary is a qualified spouse

Making adjustments for the additional information as appropriate we ran a final test on the 89 participants and determined there were 25 participants in receipt of benefit in excess of the appropriate 415 limit in effect at time of retirement.

The testing procedure does not reflect reduction of benefits for::

- Post tax employee contributions
- Post tax service purchases
- Limit adjustments for cost of living provisions contained in the SDCERS Code

Procedure and assumptions applied in the determination of the appropriate 415 limits:

1. Applicable mortality and interest rate assumptions for the calculation of actuarial equivalents are: a gender blended 50/50 GAM 83 mortality table used through December 2002 and 94 GAR mortality table projected to 2002 using the AA projection scale, thereafter with an 8% interest assumption in accordance with Code Section 415(b)(2)(E)(i).
2. DROP balances were annuitized at the date of actual retirement using the above assumptions.
3. 415 limits by age for general retirees were based on the changes in the law under EGTRRA to reflect pre-65/62 reductions.
4. Each calendar year's 415 annual limit was applied based on the year of actual retirement
5. Total annuity of each general retiree was compared to the 415 limit based on age at retirement and year of retirement.
6. For retirees qualified as public safety, comparison was made to the 415 limit based on year of retirement. There was no age adjustment made for public safety retirees.

Procedure to fill in missing information:

1. For retirees who have died, the value of their initial benefit were used and limitation applied in proportion to the a beneficiary's annuity
2. We assumed largest paying plan for retirement benefit purposes if someone had multiple ID's.
3. While we had optional forms of benefit to convert to standard life annuities or qualified survivor benefits, where information as to whether the beneficiaries under the joint and survivor options was not a qualified spouse we adjusted the benefit based on a factor determined by taking the ratio of the J&S annuity over the straight life annuity. There were only two participants affected by this adjustment.

Net Results:

1. We identified 29 retirees who violated the 415(b) limits at retirement age.

Exhibit B: Cheiron Procedures on Prospective 415(b) Testing

San Diego City Employees Retirement System

Prospective 415(b) Testing

Prospective testing will be conducted first by SDCERS through a screening process that will combine detailed information provided through Pension Gold and a calculator developed to incorporate the various benefits to be included as defined benefits. Cheiron will be involved in verification of those benefits considered within a reasonable range of the maximum limitations to verify any adjustments to be made.

The calculator -- a sample screen in Exhibit G -- incorporates the current benefits provided to City employees as non-ancillary. The process will be similar to the retrospective approach and will differ through the potential inclusion of more accurate information on the nature of funds used in the purchase of service, and rollover amounts. It is also anticipated that at some point in time post-tax employee contribution information may be available for offset in the determination of the benefit subject to testing.



415(c) Operational Process

1 Overview

This document presents the operational process implemented by SDCERS to:

1. Screen individual post-tax contributions for 415(c) compliance, prior to acceptance;
2. Screen entire active member population with post-tax contributions annually;
3. Implement a refund of contributions program for those members found to have contributed beyond the applicable 415(c) limits.

The key stakeholders in this process are:

- **Active Members** making post-tax contributions;
- **Plan Sponsors** who employ SDCERS members;
- **Member Services staff members**, responsible for qualifying and accepting post-tax contributions;
- **Member Services manager(s)**, responsible for monitoring requests for post-tax service purchase contributions, and coordinating communication and information exchange with plan sponsors;

Also responsible for annual active population screening and implementation of reduction according to priority agreed upon with plan sponsors.

The highest level process flow is as follows:

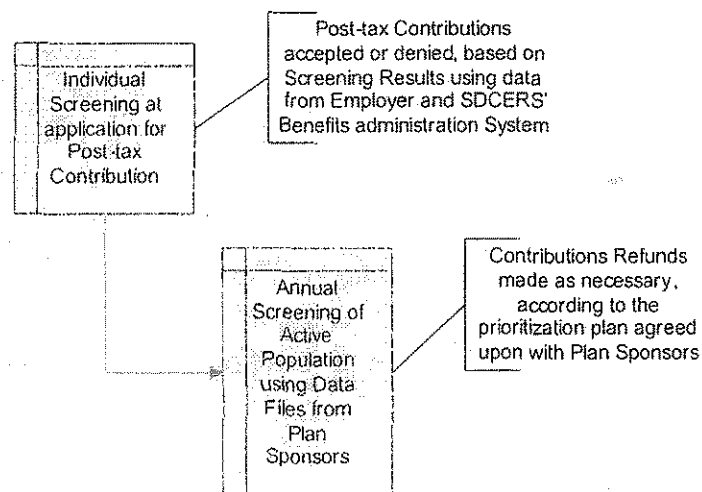


Figure 1

2 415(c) Post-tax Contribution Screening

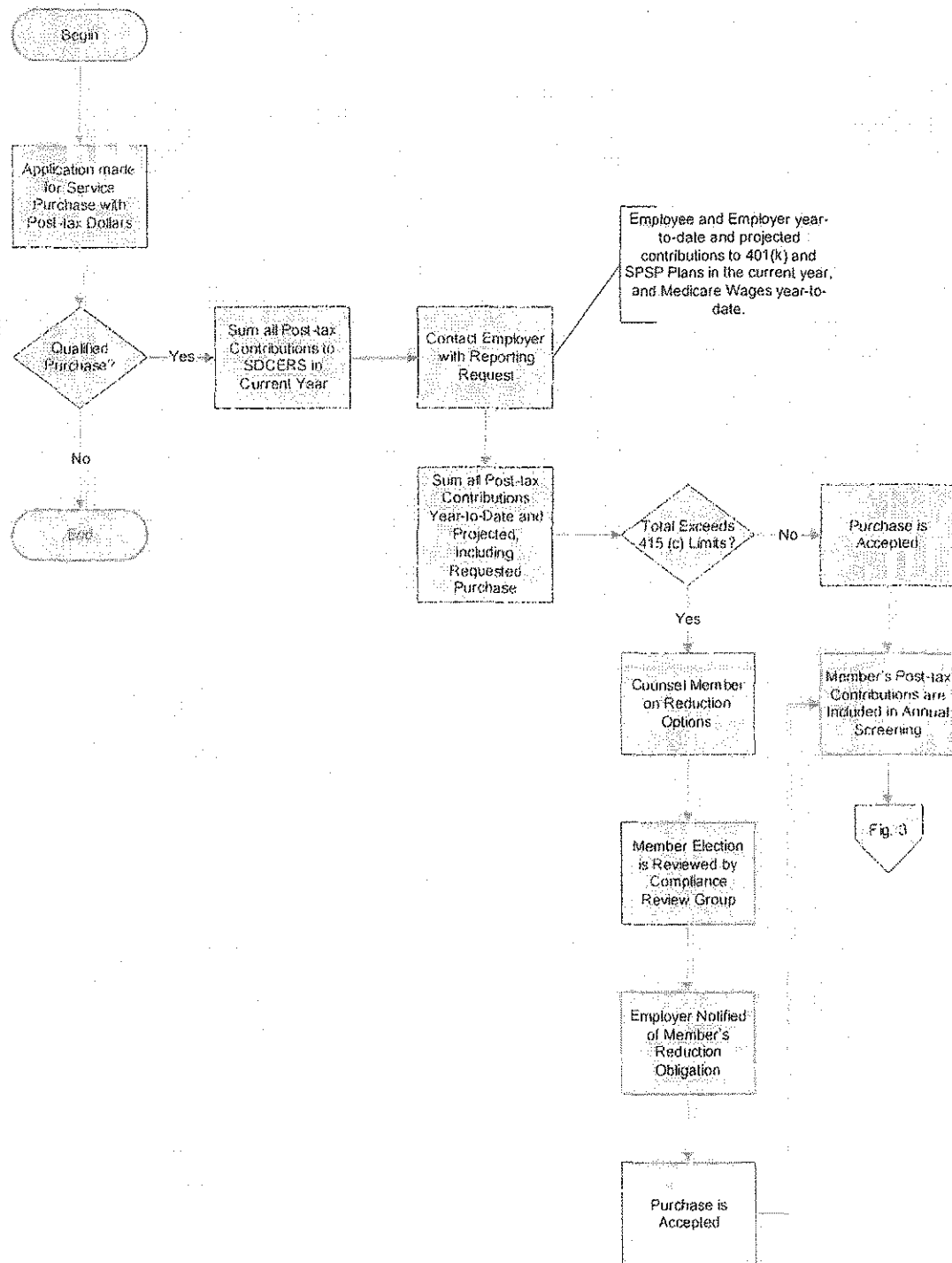



Figure 2

	Project: SDCERS Tax Compliance	Mary Anne Walker DRAFT 06/27/2006
	Document: 415(c) Operational Process	

2.1 Individual Application and Screening Process

When SDCERS is approached by an active member with a request to purchase service time using post-tax dollars, SDCERS must complete 415(c) screening prior to accepting the purchase.

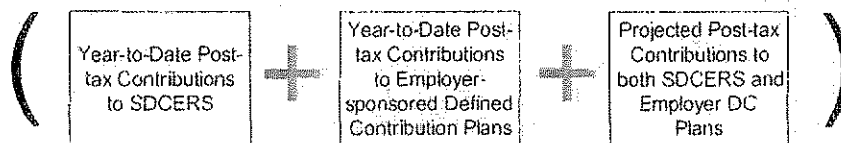
2.1.1 Aggregation of All Post-tax Annual Contributions

Step 1. Review and Qualify Application for Service Purchase

SDCERS' Member Services staff members will receive the request for service purchase from an active member, and determine whether or not the member is actually eligible to purchase the time requested.¹ If eligible to make the purchase, and the purchase is to be made with post-tax dollars for any type of service *other than permissive service credit*, the application is marked for 415(c) testing before the application and any funds have been accepted. For a detailed explanation of permissive service credit, please see the Ice Miller 415 report.

Step 2. Aggregation of Current Year Contributions

- Sum all year-to-date non-permissive service credit purchases, made with post-tax SDCERS contributions by the member.
- Contact the member's employer with a request for a report of the member's year-to-date after-tax contributions to 401(k) and SPSP plans. It is important that this report also indicate the *projected* contribution total for the current year, and that both employee and employer contributions are included. Further, the report must include the member's year-to-date Medicare wages.
- Assess the year-to-date total and projected current grand total of all post-tax contributions, including the requested service purchase.




2.1.2 Testing and Contribution Reduction

Step 3. Testing Against 415(c) Limits

- Compare the sum total of all year-to-date and projected post-tax contributions, as derived in Step 2 above, to the current year 415(c) limits. If the sum total is less

¹ This is done according to the existing process for processing service time.

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	Document: 415(c) Operational Process	

than the applicable 415(c) limit,² then the post-tax service purchase may be accepted by SDCERS.

- If the sum total is greater than the applicable limit, the member must be counseled on the need to reduce or stop his or her contributions to the employer's defined contribution plans in the current year. Reductions may also be necessary in the following year(s) if a long term service purchase contract is established with SDCERS.

$$\left(\begin{array}{|c|} \hline \text{Year-to-Date Post-tax Contributions to SDCERS} \\ \hline \end{array} \right) + \begin{array}{|c|} \hline \text{Year-to-Date Post-tax Contributions to Employer-sponsored Defined Contribution Plans} \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Projected Post-tax Contributions to both SDCERS and Employer DC Plans} \\ \hline \end{array} \right) < \begin{array}{|c|} \hline \text{Lesser of 100\% of Compensation OR Current Contribution Limit as Set by IRS} \\ \hline \end{array}$$

Step 4. Contribution Reduction

- After counseling, if the member elects to make the SDCERS service purchase and reduce contributions to the employer's DC plans, a worksheet will be given to the member, and a copy forwarded to the employer.
- The worksheet will contain the following critical information:
 1. The applicable 415(c) limit for the current year
 2. Calculations indicating the amount that will exceed the limit, if the purchase is made
 3. Required reductions, according to the following priority:
 - First: 401(k) — excess contributions refunded to the member
 - Second: SPSP - voluntary contributions only
 - Third: SDCERS — purchase total reduced
 4. Total amount of service to be purchased, and the total amount in post tax dollars to be accepted by SDCERS.
 5. Member's signed acceptance of responsibility for notifying his or her employer of the necessary reduction(s) to the DC plans.

² For detailed information on how to determine which limit will apply, please see the Ice Miller 415 Strategy Report.



2.2 Annual Screening Process

At the end of each calendar year, SDCERS will test all members from whom post-tax contributions were accepted during the year. In order to execute this test, it will be necessary to receive a data file from each of the plan sponsors. This information will be combined with post-tax contribution data from PensionGold, and analyzed. Any member found to have over-contributed during the year, will receive a refund of those excess contributions.

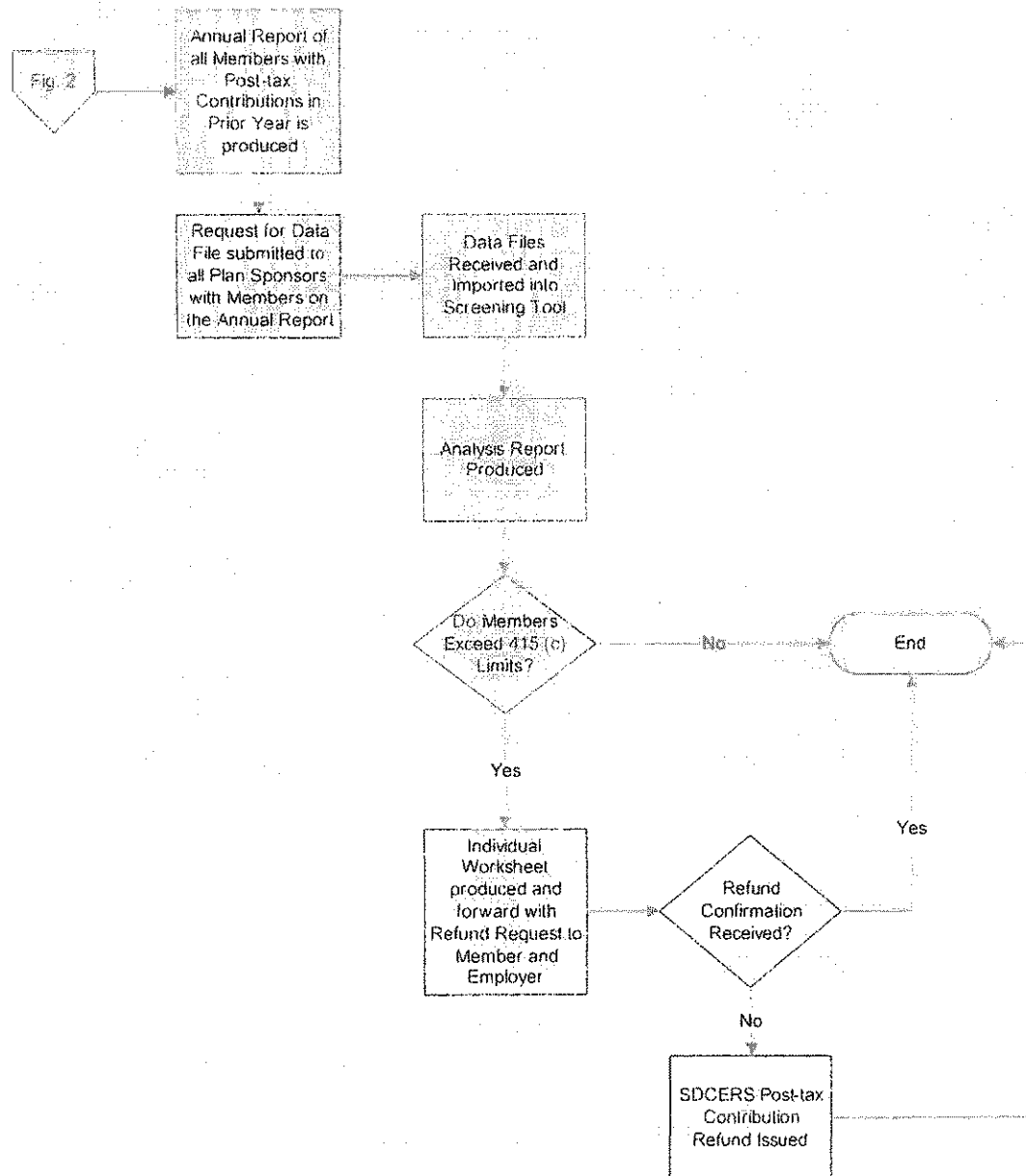



Figure 3

	Project: SDCERS Tax Compliance	Mary Anne Walker DRAFT 06/27/2006
	Document: 415(c) Operational Process	

2.2.1 Production of the Annual Report

In February of each year, the Member Services manager will produce the 415 (c) Annual Report for the previous calendar year, using the 415 Screening Tool. This report will provide a listing of all members with post-tax contributions during the previous year, along with the following information that will make it possible to request plan sponsor data:

- Name
- Employee ID or SSN
- Employer
- Total Post-tax Contributions
- 415(c) Limit (as determined at point of Service Purchase)
- Reduction Required Y/N (at the point of Service Purchase)

2.2.2 Receipt of Plan Sponsor Data

In February of each year, SDCERS will request a data file from each of its plan sponsors, to be used in 415(c) limit testing for the previous calendar year. This file must contain the following information for each of the SDCERS members requested:


- Name
- Employee ID or SSN
- Total Medicare Wages
- Total 401(k) Employee Contributions
- Total 401(k) Employer Contributions
- Total SPSP Employee Contributions
- Total SPSP Employer Contributions

When the plan sponsor's data files are received by SDCERS, they will be imported into the screening tool, and the 415(c) Annual Analysis report will be produced.

2.2.3 Production of the Annual Analysis Report

The Annual Analysis Report will return a detailed listing of all members with post-tax contributions to SDCERS in the calendar year selected by the user. The tool will use both PensionGold data and the plan sponsors' data files to determine whether the members listed have exceeded the 415(c) limit. The following information will be included for all members returned on this report:

- Name
- Employee ID or SSN

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- Employer
- Total Medicare Wages
- Total 401(k) Employee Contributions
- Total 401(k) Employer Contributions
- Total SPSP Employee Contributions
- Total SPSP Employer Contributions
- Total SDCERS Post-tax Contributions
- Grand Total Post-tax Contributions in All Plans
- 415(c) Limit
- Contribution Amount Exceeding Limit (if any)

2.2.4 Process to Return Excess Contributions

If any member on the Annual Analysis Report is found to have an amount exceeding his or her 415(c) limit, the Member Services manager will review that member's file. The file should contain the worksheet produced during the service purchase process. The file may then be referred to the Compliance Review Group for further review, as appropriate.

Step 1. Send Notification and Return of Contributions Request

Detailed communication and a completed worksheet will be sent to the member and the member's employer. This communication will clearly state the amount and source of excess contributions that must be returned to the member, according to the following priority:

First: 401(k) – excess contributions refunded to the member

Second: SPSP - voluntary contributions only

Third: SDCERS – purchase total reduced

Step 2. Receive Confirmation of Returned Contributions

This communication will include a request for confirmation of the returned contributions, once completed. If confirmation is not received within 120 days of the request, SDCERS will return the excess contributions from the member's SDCERS account, reducing service time accordingly.

Version Control

Version	Date	Changes from previous version
1.0	06/27/06	Initial Draft

Exhibit E - Chevron 415(b) Testing Assumptions

SDCERS 415 Testing Assumptions

Assumptions

- 1 Testing 415 limits on retirees who retired after January 1, 1995.
- 2 Used a blended GAM 83, or GAR 94 after 2002, mortality table, 50/50 with 8% interest assumption (the rate referred to in City Code).
- 3 The DROP account balances are annuitized using retirement age and the 50/50 blended GAM83 or GAR 94 after 2002 mortality, 8% interest.
- 4 The 415 limits are listed by year of retirement.
- 5 General retirees have limits that are adjusted by age using the mortality table from age 62 and the standard reductions from age 65 -62.
- 6 Assumed the uniformed retirees do not have an age limit.
- 7 Assume that plan ID's of 3,4,5 and 10 are uniformed.
- 8 The overall limits do not take into account employee after-tax contributions.

Benefit Database Source

Annuity is the employee provided retirement benefit
Pension is the employer provided retirement benefit
Base amount is the sum of these benefits

Plan Codes

1	Elected officials	General
2	General employees	General
3	Life guards	Uniform
4	Police	Uniform
5	Fire	Uniform
10	UPD safety	Uniform
11	UPD general	General
12	UPD executive	General

Exhibit F: Cheiron Determination of Accumulated Payments from SDCERS Over 415 Limits

Determination of Accumulated Payments From SDCERS Over 415 Limits

Total Payment	415 Limit	Actual Monthly Payment	Payment Allowed by 415 Limit	Monthly Overpayment	Retirement Date	Months Receiving Overpayment	Cumulative Overpayment	Cumulative Overpayment Through 12/31/2006
80,749.44	32,234.50	\$6,494.30	\$2,592.47	\$3,901.83	12/7/2004	25	\$105,462.16	Interest Rate 8.00%
174,381.66	104,337.01	\$14,024.71	\$8,391.34	\$5,633.37	12/31/2005	12	\$70,044.65	
125,297.20	84,094.19	\$10,077.07	\$6,763.31	\$3,313.77	11/5/2004	26	\$93,457.48	
95,573.39	66,000.00	\$7,686.53	\$5,308.07	\$2,378.45	6/29/1996	126	\$459,725.96	Total Overpayment \$2,266,162
196,467.78	139,213.68	\$15,801.00	\$11,196.31	\$4,604.68	4/27/2005	20	\$97,946.09	
140,595.47	101,268.27	\$11,307.44	\$8,144.54	\$3,162.90	4/22/2004	32	\$111,987.52	
118,119.92	92,228.73	\$9,499.84	\$7,417.53	\$2,082.31	11/4/2004	26	\$58,726.90	
183,212.74	143,308.20	\$14,734.95	\$11,525.62	\$3,209.34	2/3/2005	11	\$36,460.62	
82,918.26	66,000.00	\$6,668.73	\$5,308.07	\$1,360.66	6/10/1995	139	\$304,253.95	
102,562.68	84,094.19	\$8,248.64	\$6,763.31	\$1,485.33	12/18/2004	24	\$38,414.45	
97,825.53	80,917.50	\$7,867.66	\$6,507.82	\$1,359.84	7/20/2002	53	\$85,559.52	
162,189.77	135,119.16	\$13,044.17	\$10,867.01	\$2,177.16	9/24/2004	27	\$63,974.31	
104,834.23	89,433.92	\$8,431.33	\$7,192.76	\$1,238.58	10/11/2003	39	\$54,706.49	
87,908.99	75,000.00	\$7,070.11	\$6,031.90	\$1,038.21	9/17/2001	63	\$80,337.84	
112,545.97	98,199.53	\$9,051.55	\$7,897.73	\$1,153.82	12/16/2003	37	\$48,027.73	
98,603.25	86,642.50	\$7,930.20	\$6,968.26	\$961.95	2/12/2005	23	\$23,763.51	
176,521.25	160,000.00	\$14,196.79	\$12,868.06	\$1,328.73	4/1/2002	57	\$91,141.12	
72,752.52	66,000.00	\$5,851.15	\$5,308.07	\$543.07	3/18/1995	141	\$124,092.98	
143,013.87	130,000.00	\$11,501.94	\$10,455.30	\$1,046.65	12/7/1999	85	\$117,913.96	
138,172.60	129,990.90	\$11,112.58	\$10,454.57	\$658.02	3/9/2006	10	\$6,773.98	
168,744.21	160,000.00	\$13,571.32	\$12,868.06	\$703.26	4/1/2002	57	\$48,238.31	
78,702.02	75,000.00	\$6,329.64	\$6,031.90	\$297.74	10/3/1998	99	\$41,040.91	
68,748.96	66,000.00	\$5,529.16	\$5,308.07	\$221.09	4/1/1996	129	\$44,230.95	
91,540.70	89,190.81	\$7,370.24	\$7,173.20	\$197.03	1/17/2006	11	\$2,236.45	
122,044.40	120,000.00	\$9,815.47	\$9,651.05	\$164.42	1/6/1995	144	\$31,298.06	Member Died 1/8/2001
76,213.24	75,000.00	\$6,129.48	\$6,031.90	\$97.57	3/31/2001	69	\$8,441.61	
105,880.34	104,337.01	\$8,515.47	\$8,391.34	\$124.12	4/15/2005	21	\$2,781.34	
76,044.23	75,000.00	\$6,115.89	\$6,031.90	\$83.98	7/6/2000	78	\$8,472.96	
75,532.35	75,000.00	\$6,074.72	\$6,031.90	\$42.81	12/31/1997	108	\$6,647.75	

San Diego City Employees' Retirement System IRS Section 415 Individual Testing

A. Member Information

Assumed Actuarial Interest Rate (8.00%)	8.00%
Current Date	1/1/2007
Name:	john
Social Security Number:	100-00-0000
Gender:	Male
Date of Birth:	1/1/1950
Date of Retirement:	1/1/2007
Total Service:	25.00
Plan ID:	3 = City Lifeguard

B. Annual Payment

Annual Annuity:	\$1,000.00
Annual Pension:	\$185,000.00

C. Joint Survivor Adjustment

Benefit Option:	Joint Survivor
Qualified J&S?	No
Joint Survivor %:	100%
Beneficiary's Date of Birth:	1/1/1955

D. DROP Annuity Information

DROP Annuity Elected:	Yes
DROP Annuity Option:	Grandfathered
Annuity Effective Date:	1/1/2007
DROP Contribution Amount:	\$300,000.00
DROP Interest Amount:	\$100,000.00

E. Member Results

Name:	john
Social Security Number:	100-00-0000
Annual Base:	\$186,000.00
Joint Survivor Adjustment:	\$22,873.48
DROP Annuity:	\$36,232.26
Corbett:	\$0.00
13th Check:	\$750.00

F. 415 Limit Test

Total Annual Payment:	\$245,855.75
Annual 415 Limit:	
Ratio:	

Exhibit H: Cheiron General Employee Limits

General - Blended - SSNRA = 65

Age	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
35	75,000	75,000	75,000	75,000	75,000	75,000	75,000	14,947	14,947	15,414	15,881	16,348
36	75,000	75,000	75,000	75,000	75,000	75,000	75,000	15,838	16,204	16,710	17,217	17,723
37	75,000	75,000	75,000	75,000	75,000	75,000	75,000	16,767	17,571	18,120	18,669	19,218
38	75,000	75,000	75,000	75,000	75,000	75,000	75,000	17,735	19,058	19,654	20,249	20,845
39	75,000	75,000	75,000	75,000	75,000	75,000	75,000	18,741	20,678	21,324	21,970	22,616
40	75,000	75,000	75,000	75,000	75,000	75,000	75,000	19,785	22,442	23,144	23,845	24,546
41	75,000	75,000	75,000	75,000	75,000	75,000	75,000	20,866	24,366	25,127	25,889	26,650
42	75,000	75,000	75,000	75,000	75,000	75,000	75,000	21,983	26,464	27,291	28,118	28,945
43	75,000	75,000	75,000	75,000	75,000	75,000	75,000	23,137	28,755	29,654	30,552	31,451
44	75,000	75,000	75,000	75,000	75,000	75,000	75,000	24,328	31,268	32,235	33,211	34,188
45	75,000	75,000	75,000	75,000	75,000	75,000	75,000	25,556	33,994	35,056	36,119	37,181
46	75,000	75,000	75,000	75,000	75,000	75,000	75,000	26,821	36,989	38,145	39,301	40,457
47	75,000	75,000	75,000	75,000	75,000	75,000	75,000	28,123	40,269	41,528	42,786	44,045
48	75,000	75,000	75,000	75,000	75,000	75,000	75,000	29,462	43,867	45,238	46,609	47,980
49	75,000	75,000	75,000	75,000	75,000	75,000	75,000	30,837	47,817	49,311	50,805	52,299
50	75,000	75,000	75,000	75,000	75,000	75,000	75,000	32,249	52,158	53,788	55,418	57,047
51	75,000	75,000	75,000	75,000	75,000	75,000	75,000	33,698	56,935	58,714	60,494	62,273
52	75,000	75,000	75,000	75,000	75,000	75,000	75,000	35,183	62,200	64,144	66,088	68,032
53	75,000	75,000	75,000	75,000	75,000	75,000	75,000	36,704	68,011	70,137	72,262	74,387
54	75,000	75,000	75,000	75,000	75,000	75,000	75,000	38,261	74,434	76,760	79,086	81,412
55	75,000	75,000	75,000	75,000	75,000	75,000	75,000	39,854	81,546	84,094	86,643	89,191
56	75,000	75,000	75,000	75,000	75,000	75,000	75,000	41,483	89,434	92,229	95,024	97,818
57	75,000	75,000	75,000	75,000	75,000	75,000	75,000	43,148	98,200	101,268	104,337	107,406
58	75,000	75,000	75,000	75,000	75,000	75,000	75,223	107,001	107,959	111,333	114,707	118,081
59	75,000	75,000	75,000	75,000	76,978	76,978	79,938	118,427	118,849	122,563	126,277	129,991
60	78,423	78,423	81,691	84,959	84,959	88,226	91,494	130,700	131,025	135,119	139,214	143,308
61	86,693	86,693	90,305	93,917	93,917	97,529	101,141	144,433	144,670	149,191	153,712	158,233
62	96,000	96,000	100,000	104,000	104,000	108,000	112,000	160,000	160,000	165,000	170,000	175,000
63	104,000	104,000	108,333	112,667	112,667	117,000	121,333	180,000	180,000	185,000	190,000	195,000
64	112,000	112,000	116,667	121,333	121,333	126,000	130,667	190,000	190,000	195,000	200,000	205,000
65	120,000	120,000	125,000	130,000	130,000	135,000	140,000	200,000	200,000	205,000	210,000	215,000
66	120,000	120,000	125,000	130,000	130,000	135,000	140,000	200,000	200,000	205,000	210,000	215,000
67	120,000	120,000	125,000	130,000	130,000	135,000	140,000	200,000	200,000	205,000	210,000	215,000

General - Blended - SSNRA = 66

Age	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
35	75,000	75,000	75,000	75,000	75,000	75,000	75,000	14,947	14,947	15,414	15,881	16,348
36	75,000	75,000	75,000	75,000	75,000	75,000	75,000	15,839	16,204	16,710	17,217	17,723
37	75,000	75,000	75,000	75,000	75,000	75,000	75,000	16,732	17,571	18,120	18,669	19,218
38	75,000	75,000	75,000	75,000	75,000	75,000	75,000	17,625	18,958	19,654	20,249	20,845
39	75,000	75,000	75,000	75,000	75,000	75,000	75,000	18,517	20,678	21,324	21,970	22,616
40	75,000	75,000	75,000	75,000	75,000	75,000	75,000	19,410	22,442	23,144	23,845	24,546
41	75,000	75,000	75,000	75,000	75,000	75,000	75,000	20,302	24,366	25,127	25,889	26,650
42	75,000	75,000	75,000	75,000	75,000	75,000	75,000	21,195	26,464	27,291	28,118	28,945
43	75,000	75,000	75,000	75,000	75,000	75,000	75,000	22,087	28,755	29,654	30,552	31,451
44	75,000	75,000	75,000	75,000	75,000	75,000	75,000	22,980	31,258	32,235	33,211	34,188
45	75,000	75,000	75,000	75,000	75,000	75,000	75,000	23,872	33,994	35,056	36,119	37,181
46	75,000	75,000	75,000	75,000	75,000	75,000	75,000	24,765	36,969	38,145	39,301	40,457
47	75,000	75,000	75,000	75,000	75,000	75,000	75,000	25,657	40,269	41,528	42,786	44,045
48	75,000	75,000	75,000	75,000	75,000	75,000	75,000	26,550	43,867	45,238	46,609	47,980
49	75,000	75,000	75,000	75,000	75,000	75,000	75,000	27,442	47,817	49,311	50,805	52,299
50	75,000	75,000	75,000	75,000	75,000	75,000	75,000	28,335	52,158	53,788	55,418	57,047
51	75,000	75,000	75,000	75,000	75,000	75,000	75,000	29,227	56,835	58,714	60,494	62,273
52	75,000	75,000	75,000	75,000	75,000	75,000	75,000	30,120	62,200	64,144	66,088	68,032
53	75,000	75,000	75,000	75,000	75,000	75,000	75,000	31,012	68,011	70,137	72,262	74,387
54	75,000	75,000	75,000	75,000	75,000	75,000	75,000	31,905	74,434	76,760	79,086	81,412
55	75,000	75,000	75,000	75,000	75,000	75,000	75,000	32,797	81,546	84,094	86,643	89,191
56	75,000	75,000	75,000	75,000	75,000	75,000	75,000	33,690	89,434	92,229	95,024	97,818
57	75,000	75,000	75,000	75,000	75,000	75,000	75,000	34,582	98,200	101,268	104,337	107,406
58	75,000	75,000	75,000	75,000	75,000	75,000	75,000	35,475	107,959	111,333	114,707	118,081
59	75,000	75,000	75,000	75,000	75,000	75,000	77,718	413,707	118,849	122,563	126,277	129,991
60	75,000	75,000	76,585	79,649	79,649	82,712	85,776	130,700	131,025	135,119	139,214	143,308
61	81,274	81,274	84,661	88,047	88,047	91,434	94,820	144,469	144,670	149,191	153,712	158,233
62	90,000	90,000	93,750	97,500	97,500	101,250	105,000	160,000	160,000	165,000	170,000	175,000
63	98,000	98,000	102,083	106,167	106,167	110,250	114,333	160,000	160,000	165,000	170,000	175,000
64	106,000	106,000	110,417	114,833	114,833	119,250	123,667	160,000	160,000	165,000	170,000	175,000
65	114,000	114,000	118,750	123,500	123,500	128,250	133,000	160,000	160,000	165,000	170,000	175,000
66	120,000	120,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
67	120,000	120,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000

General - Blended - SSNRA =67

Age	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
35	75,000	75,000	75,000	75,000	75,000	75,000	75,000	14,905	14,947	15,414	15,881	16,348
36	75,000	75,000	75,000	75,000	75,000	75,000	75,000	15,839	16,204	16,710	17,217	17,723
37	75,000	75,000	75,000	75,000	75,000	75,000	75,000	17,107	17,571	18,120	18,669	19,218
38	75,000	75,000	75,000	75,000	75,000	75,000	75,000	18,648	19,056	19,654	20,249	20,845
39	75,000	75,000	75,000	75,000	75,000	75,000	75,000	20,441	20,678	21,324	21,970	22,616
40	75,000	75,000	75,000	75,000	75,000	75,000	75,000	21,688	22,442	23,144	23,845	24,546
41	75,000	75,000	75,000	75,000	75,000	75,000	75,000	23,479	24,366	25,127	25,889	26,650
42	75,000	75,000	75,000	75,000	75,000	75,000	75,000	25,993	26,464	27,291	28,118	28,945
43	75,000	75,000	75,000	75,000	75,000	75,000	75,000	28,247	28,755	29,654	30,552	31,451
44	75,000	75,000	75,000	75,000	75,000	75,000	75,000	30,696	31,258	32,235	33,211	34,186
45	75,000	75,000	75,000	75,000	75,000	75,000	75,000	32,409	33,994	35,056	36,110	37,161
46	75,000	75,000	75,000	75,000	75,000	75,000	75,000	35,902	36,989	38,145	39,301	40,457
47	75,000	75,000	75,000	75,000	75,000	75,000	75,000	38,644	40,269	41,528	42,788	44,045
48	75,000	75,000	75,000	75,000	75,000	75,000	75,000	42,225	43,867	45,238	46,609	47,980
49	75,000	75,000	75,000	75,000	75,000	75,000	75,000	47,162	47,817	49,311	50,805	52,299
50	75,000	75,000	75,000	75,000	75,000	75,000	75,000	51,494	52,158	53,788	55,418	57,047
51	75,000	75,000	75,000	75,000	75,000	75,000	75,000	56,262	56,935	58,714	60,494	62,273
52	75,000	75,000	75,000	75,000	75,000	75,000	75,000	61,332	62,200	64,144	66,088	68,032
53	75,000	75,000	75,000	75,000	75,000	75,000	75,000	67,349	68,011	70,197	72,282	74,367
54	75,000	75,000	75,000	75,000	75,000	75,000	75,000	74,787	74,434	76,766	79,086	81,412
55	75,000	75,000	75,000	75,000	75,000	75,000	75,000	80,917	81,546	84,084	86,643	89,191
56	75,000	75,000	75,000	75,000	75,000	75,000	75,000	88,620	89,434	92,225	95,024	97,818
57	75,000	75,000	75,000	75,000	75,000	75,000	75,000	97,800	98,200	101,268	104,337	107,405
58	75,000	75,000	75,000	75,000	75,000	75,000	75,000	107,480	107,959	111,133	114,707	118,081
59	75,000	75,000	75,000	75,000	75,000	75,000	75,000	118,127	118,849	122,563	126,277	129,991
60	75,000	75,000	75,000	75,000	75,000	77,198	80,057	130,706	131,025	135,119	139,214	143,368
61	75,856	75,856	79,017	82,177	82,177	85,338	88,499	144,180	144,670	149,191	153,712	158,233
62	84,000	84,000	87,500	91,000	91,000	94,500	98,000	160,000	160,000	165,000	170,000	175,000
63	92,000	92,000	95,833	99,667	99,667	103,500	107,333	160,000	160,000	165,000	170,000	175,000
64	100,000	100,000	104,167	108,333	108,333	112,500	116,667	160,000	160,000	165,000	170,000	175,000
65	108,000	108,000	112,500	117,000	117,000	121,500	126,000	160,000	160,000	165,000	170,000	175,000
66	114,000	114,000	118,750	123,500	123,500	128,250	133,000	160,000	160,000	165,000	170,000	175,000
67	120,000	120,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000

Exhibit I: Cheiron Uniform/Safety Employee Limits

Uniform- Blended

Age	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
46	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
47	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
48	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
49	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
50	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
51	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
52	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
53	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
54	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
55	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
56	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
57	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
58	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
59	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
60	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
61	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
62	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
63	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
64	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
65	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
66	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000
67	66,000	66,000	125,000	130,000	130,000	135,000	140,000	160,000	160,000	165,000	170,000	175,000

Exhibit J: Cheiron Sample Description of Testing Data

Sample Life With Cell Descriptions

A	Ratio	= AO / AP	1.10	- ratio of annual compensation to 415 Limit. If > 1 then the person is over the 415 limit
B	SSN	GIVEN		- member's SSN
C	FName	GIVEN		- member's first name
D	LName	GIVEN		- member's last name
E	Date of Birth	GIVEN	1/1/1940	- member's date of birth; used for calculating ages
F	Gender	GIVEN	M	- member's gender; used for finding J&S %
G	Age at Ret	Calculated	60	- rounded age of person; difference between DOB and DOR; used for finding 415 limit and J&S %
H	Soc Sec NRA	Calculated	68	- if YOB < 1937 then 65, if 1937 < YOB < 1955 then 66, if 1955 < YOB then 67; used in finding 415 limit
I	Date of Retirement	GIVEN	12/7/1999	- member's retirement date; used for Corbett, 415 limit and appropriate mortality conversion tables
J	Total Service	GIVEN	35.74	- member's service; used for calculating 13th Check
K	Plan ID	GIVEN	4	- See "Assumptions" tab for Plan ID explanation; uniform and general members receive a different 415 limit.
L	Safety Svc > 15 years	GIVEN	NO	- if not a Uniform Plan ID, but earned 15 years of qualified uniform code service - eligible to receive Uniform 415 limit
M	Ben Type	GIVEN	SRET	- type of retirement; used in calculating 13th check
N	Ben Option	GIVEN	JSURV	- benefit payment option selected by member; used in determining J&S adjustment
O	J&S %	GIVEN	60	- election percent for survivor; used in determining J&S adjustment
P	Ben DOB	GIVEN	1/15/1940	- DOB for survivor of member; used to find J&S adjustment
Q	Age Difference	Calculated	0	- member's age - survivor's age = age difference, maximum 20, minimum -20; used in determining J&S adjustment
R	415 Annuity	GIVEN	\$11,999.88	- annual amount received by a member, based off of member contributions
S	415 Pension	GIVEN	\$90,973.68	- annual amount received by a member, based off of employer contributions
T	415 Base Amt	= R + S	\$102,973.56	= R + S - total base annuity
U	DROP Annuity Elected	GIVEN	YES	- states whether a person has elected a DROP
V	DROP Annuity Option	GIVEN	Life Expectancy	- explains the option selected by the member for receipt of DROP; used in calculating years of DROP annuity
W	Annuity Effective Date	GIVEN	1/1/2000	- when a member starts to receive DROP annuity
X	n-years	Calculated	25.2	- length of annuity DROP, 20 years, Grandfathered and Life Expectancy, based on age, "1" is code for annuity
Y	DROP Retirement Date	GIVEN	12/7/1999	- when member entered into DROP program; used to calculate annuity payment
Z	DROP Cont	GIVEN	\$399,775.89	- contributions made to DROP account; used to calculate balance
AA	DROP Int	GIVEN	\$30,140.01	- interest earned on DROP account; used to calculate balance
AB	DROP Balance	= Z + AA	\$339,915.90	= Z + AA; total account used to calculate annual payment to a member from DROP account
AC	DROP Annuity Payment	Calculated	\$31,759.96	- annual DROP payment as PV, using 8% and n-years; if n-years is "1", then SLA, mortality based on DROP entry
AD	Applicable Rollover	GIVEN	NO	- States whether a person has a rollover contribution received for 401K or SPSP purposes only
AE	Pre-Tax Rollover	GIVEN		- Pre Tax Contribution Rollover Reported
AF	Post Tax Rollover	GIVEN		- Post Tax Contribution Rollover Reported
AG	Total Rollover	= AE + AF		= AE + AF
AH	Annuitized Rollover	Calculated	\$0.00	- total Rollover annuitized based on payment form elected and retirement date
AI	Spouse is Benef	GIVEN	YES	- states whether a person has a qualified spouse as the survivor beneficiary
AJ	J&S % Adjustment	Calculated	0.00%	- no adjustment if beneficiary is qualified spouse, otherwise represent J&S/Straight Life annuity factors
AK	J&S Adjusted Amount	= AJ * T	\$0.00	= AJ * T - elected for adjusted to a Straight Life annuity
AL	Corbett Settlement	Calculated	\$7,208.15	- retirees prior to 7/1/2000, 7% * T, as Corbett Settlement. members after 7/1/2000 already have benefit included.
AM	13th Check	Calculated	\$1,072.20	- 30*Svc (J), if no service is provided, 10 years of service is assumed.
AN				
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$143,013.97	= T + AC + AK + AL + AM - AH
AP	415 Limit	Calculated	\$130,000.00	- Member's 415 Limit based on Uniform or General, Age at retirement, Soc Sec NRA, at actual retirement
AQ	Ratio	= AO / AP	1.10	- ratio of annual compensation to 415 Limit. If > 1 then the person is over the 415 limit.

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

		1	2	3	4	5	6	7	8	9
A	Ratio	= AO / AP	2.51	1.67	1.49	1.45	1.41	1.39	1.28	1.26
B	SSN	GIVEN								
C	FName	GIVEN								
D	LName	GIVEN								
E	Date of Birth	GIVEN	9/7/1960	12/2/1948	11/5/1948	12/1/1939	3/19/1945	2/25/1947	8/31/1948	11/11/1945
F	Gender	GIVEN	M	M	M	M	M	M	M	M
G	Age at Ret	Calculated	44	57	55	57	60	57	55	60
H	Soc Sec NRA	Calculated	67	66	66	66	66	66	66	66
I	Date of Retirement	GIVEN	12/7/2004	12/31/2005	11/5/2004	8/29/1996	4/27/2005	4/22/2004	11/4/2004	2/3/2006
J	Total Service	GIVEN	24.28	33.88	37.69	34.33	39.12	36.25	36.00	35.93
K	Plan ID	GIVEN	2	2	2	4	2	2	2	4
L	Safety Svc > 15 years	GIVEN	NO	NO	NO	NO	NO	NO	NO	YES
M	Ben Type	GIVEN	SRET	DROPC	DEFER	SRET	SRET	SRET	DROPC	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	SLIFE	JSURV
O	J&S %	GIVEN	100	50	50	50	50	50	0	50
P	Ben DOB	GIVEN	6/29/1959	9/11/1960	2/20/2004	9/15/1941	2/25/1945	6/30/1947		12/15/1940
Q	Age Difference	Calculated	-1	12	20	2	0	0		4
R	415 Annuity	GIVEN	\$9,843.00	\$15,578.28	\$15,222.24	\$11,999.88	\$11,999.88	\$12,639.72	\$11,170.32	\$11,514.24
S	415 Pension	GIVEN	\$76,044.48	\$125,516.28	\$108,844.16	\$76,358.52	\$119,599.88	\$112,667.84	\$93,230.76	\$119,740.44
T	415 Base Amt	= R + S	\$85,887.48	\$141,094.56	\$124,166.40	\$88,358.40	\$131,999.76	\$125,307.36	\$104,401.08	\$137,051.88
U	DROP Annuity Elected	GIVEN	NO	YES	NO	NO	NO	YES	NO	YES
V	DROP Annuity Option	GIVEN		Life Expectancy			Grandfathered	Life Expectancy	Grandfathered	240 Months
W	Annuity Effective Date	GIVEN		1/1/2006				1/1/2006		3/1/2006
X	n-years	Calculated	1	27.9	1	1	25.2	27.9	28.7	1
Y	DROP Retirement Date	GIVEN		12/31/2005			4/27/2005	4/22/2004	11/4/2004	2/3/2006
Z	DROP Cont	GIVEN		\$328,159.36			\$640,245.64	\$205,770.79	\$135,314.90	\$485,854.44
AA	DROP Int	GIVEN		\$28,112.84			\$112,012.15	\$11,552.69	\$5,317.50	\$59,746.56
AB	DROP Balance	= Z + AA		\$356,272.20			\$752,257.79	\$217,323.48	\$140,632.40	\$545,601.00
AC	DROP Annuity Payment	Calculated	\$0.00	\$32,271.37	\$0.00	\$0.00	\$70,287.02	\$19,665.30	\$12,638.75	\$55,570.67
AD	Applicable Rollover	GIVEN	YES	NO	NO	NO	YES	YES	NO	YES
AE	Pre-Tax Rollover	GIVEN	\$105,513.81	\$92,163.38	\$106,202.81	\$0.00	\$93,418.32	\$80,966.52	\$0.00	\$107,155.08
AF	Post Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$4,507.84	\$0.00	\$0.00	\$194.19
AG	Total Rollover	= AE + AF	\$105,513.81	\$92,163.38	\$106,202.81	\$0.00	\$97,926.16	\$80,966.52	\$0.00	\$107,155.08
AH	Annuitized Rollover	Calculated	\$5,865.54	\$0.00	\$0.00	\$0.00	\$6,992.60	\$5,484.79	\$0.00	\$10,490.26
AI	Spouse is Bene.	GIVEN	YES	YES	YES	YES	YES	YES	#N/A	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$0.00	\$0.00	\$5,185.09	\$0.00	\$0.00	\$0.00	\$5,354.04
AM	13th Check	Calculated	\$728.49	\$1,015.73	\$1,130.80	\$1,029.90	\$1,173.60	\$1,087.60	\$1,080.07	\$1,077.90
AN										
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$80,749.44	\$174,381.66	\$125,297.20	\$95,573.39	\$196,467.78	\$140,595.47	\$118,119.92	\$183,212.74
AP	415 Limit	Calculated	\$32,234.50	\$104,337.01	\$84,094.19	\$66,000.00	\$139,213.68	\$101,268.27	\$92,228.73	\$143,308.20
AQ	Ratio	= AO / AP	2.51	1.67	1.49	1.45	1.41	1.39	1.28	1.26

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

			10	11	12	13	14	15	16	17	18
	Ratio	= AO / AP	1.22	1.21	1.20	1.17	1.17	1.15	1.13	1.10	1.10
B	SSN	GIVEN									
C	FName	GIVEN									
D	LName	GIVEN									
E	Date of Birth	GIVEN	10/8/1949	3/29/1947	8/23/1944	2/17/1948	6/13/1943	10/23/1946	9/11/1949	6/11/1935	9/11/1946
F	Gender	GIVEN	F	F	M	F	M	F	M	M	M
G	Age at Ret	Calculated	55	55	60	56	58	57	58	57	58
H	Soc Sec NRA	Calculated	66	66	66	66	66	66	66	65	66
I	Date of Retirement	GIVEN	12/16/2004	7/26/2002	9/24/2004	10/11/2003	9/17/2001	12/16/2003	2/12/2005	4/1/2002	3/18/1995
J	Total Service	GIVEN	35.00	38.17	39.01	32.00	29.44	40.83	35.20	37.68	29.11
K	Plan ID	GIVEN	2	2	2	2	2	2	2	2	5
L	Safety Svc > 15 years	GIVEN	NO	NO	NO	NO	NO	NO	NO	NO	YES
M	Ben Type	GIVEN	SRET	SRET	SRET	SRET	SRET	SRET	SRET	SRET	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	SLIFE	SLIFE	JSURV	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	60	0	0	50	50	50	50
P	Ben DOB	GIVEN	6/7/1954	10/13/1945	6/20/1945			5/18/1942	10/11/1947	2/8/1937	7/15/1947
Q	Age Difference	Calculated	5	-1	1			-4	-2	2	7
R	415 Annuity	GIVEN	\$13,270.00	\$10,285.56	\$14,342.16	\$10,700.28	\$11,999.88	\$10,397.16	\$12,102.48	\$11,999.88	\$9,291.72
S	415 Pension	GIVEN	\$83,212.60	\$68,454.84	\$94,262.80	\$94,244.28	\$83,520.48	\$93,490.44	\$87,153.24	\$95,427.84	\$67,885.12
T	415 Base Amt	= R + S	\$101,482.68	\$78,740.40	\$108,594.96	\$104,944.56	\$95,520.36	\$103,887.60	\$99,255.72	\$107,427.72	\$67,176.84
U	DROP Annuity Elected	GIVEN	NO	NO	YES	NO	NO	NO	NO	NO	NO
V	DROP Annuity Option	GIVEN			240 Months	Grandfathered		Grandfathered	Grandfathered	Grandfathered	
W	Annuity Effective Date	GIVEN			1/1/2006						
X	n-years	Calculated	1	1	20	28.7	1	27.9	29.6	19.4	1
Y	DROP Retirement Date	GIVEN			9/24/2004	10/11/2003		12/16/2003	2/12/2005	4/1/2002	
Z	DROP Cont	GIVEN			\$453,147.26	\$53,720.43		\$133,858.49	\$12,612.98	\$612,696.56	
AA	DROP Int	GIVEN			\$81,564.96	\$223.52		\$4,199.33	\$0.00	\$130,832.98	
AB	DROP Balance	= Z + AA			\$514,712.22	\$54,643.95		\$138,068.82	\$12,612.98	\$743,523.54	
AC	DROP Annuity Payment	Calculated	\$0.00	\$0.00	\$82,424.58	\$4,910.90	\$0.00	\$12,506.09	\$1,124.26	\$76,719.90	\$0.00
AD	Applicable Rollover	GIVEN	NO	NO	NO	YES	YES	YES	YES	YES	NO
AE	Pre-Tax Rollover	GIVEN	\$81,701.68	\$87,603.74	\$0.00	\$64,828.90	\$88,405.08	\$76,731.61	\$42,825.86	\$84,311.48	\$0.00
AF	Post-Tax Rollover	GIVEN	\$753.07	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$82,454.75	\$87,603.74	\$0.00	\$64,828.90	\$88,405.08	\$76,731.61	\$42,825.86	\$84,311.48	\$0.00
AH	Annuitized Rollover	Calculated	\$0.00	\$0.00	\$0.00	\$5,981.23	\$8,494.57	\$5,072.58	\$2,832.62	\$9,755.16	\$0.00
AI	Spouse Is Bene.	GIVEN	YES	YES	YES	#N/A	#N/A	YES	YES	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$4,702.38
AM	13th Check	Calculated	\$1,080.00	\$1,085.13	\$1,170.23	\$960.00	\$883.20	\$1,224.85	\$1,055.89	\$1,129.80	\$873.30
AN											
AO	Total Annual Compensation	= T + AG + AK + AL + AM - AH	\$192,562.68	\$97,825.83	\$162,189.77	\$104,834.23	\$87,908.99	\$112,543.97	\$90,603.25	\$176,521.25	\$72,752.52
AP	415 Limit	Calculated	\$84,094.19	\$80,917.50	\$135,119.16	\$89,433.92	\$75,000.00	\$98,199.53	\$86,642.50	\$160,000.00	\$66,000.00
AQ	Ratio	= AO / AP	1.22	1.21	1.20	1.17	1.17	1.15	1.13	1.10	1.10

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

			19	20	21	22	23	24	25	26	27
	Ratio	= AO / AP	1.10	1.08	1.06	1.05	1.04	1.03	1.02	1.02	1.01
B	SSN	GIVEN									
C	FName	GIVEN									
D	LName	GIVEN									
E	Date of Birth	GIVEN	1/1/1940	7/28/1947	10/1/1937	10/1/1940	3/1/1943	1/16/1951	12/7/1929	3/15/1946	7/18/1948
F	Gender	GIVEN	M	F	M	M	M	F	F	F	M
G	Age at Ret	Calculated	60	59	65	58	53	55	65	55	57
H	Soc Sec NRA	Calculated	66	66	66	58	66	66	65	66	66
I	Date of Retirement	GIVEN	12/7/1999	3/9/2006	4/1/2002	10/3/1998	4/1/1996	1/17/2006	1/6/1995	3/31/2001	4/15/2005
J	Total Service	GIVEN	35.74	37.89	26.34	33.73	31.09	25.47	34.97	40.23	25.81
K	Plan ID	GIVEN	4	2	5	2	4	2	11	2	2
L	Safety Svc >15 years	GIVEN	YES	NO	YES	NO	NO	NO	NO	NO	NO
M	Ben Type	GIVEN	SRET	DROPC	SRET	SRET	SRET	SRET	CONT	SRET	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	SLIFE	JSURV	JSURV	SLIFE	JSURV	JSURV
O	J&S %	GIVEN	50	50	50	0	50	50	0	50	100
P	Ben DOB	GIVEN	1/15/1940	8/2/1950	2/8/1966		12/15/1943	12/26/1947	6/4/1941	6/15/1944	9/23/1948
Q	Age Difference	Calculated	0	3	20		1	-3		-2	0
R	415 Annuity	GIVEN	\$11,999.88	\$11,691.96	\$7,345.44	\$11,999.88	\$9,765.12	\$14,083.80	\$15,113.52	\$10,876.60	\$15,050.52
S	415 Pension	GIVEN	\$90,973.88	\$89,173.92	\$92,214.12	\$64,722.60	\$53,614.56	\$76,792.80	\$97,966.20	\$69,550.12	\$74,355.98
T	415 Base Amt	= R + S	\$102,973.56	\$100,865.88	\$99,559.56	\$76,722.48	\$63,379.68	\$90,876.60	\$113,079.72	\$80,428.92	\$89,412.48
U	DROP Annuity Elected	GIVEN	YES	YES	YES	NO	NO	NO	NO	NO	NO
V	DROP Annuity Option	GIVEN	Life Expectancy	240 Months	Life Expectancy	Grandfathered					
W	Annuity Effective Date	GIVEN	1/1/2006	4/1/2006	1/1/2006						
X	n-years	Calculated	25.2	20	21	27	1	1	1	1	1
Y	DROP Retirement Date	GIVEN	12/7/1999	3/9/2006	4/1/2002	10/3/1998					
Z	DROP Cont	GIVEN	\$309,775.89	\$361,543.01	\$664,612.83	\$133,651.47					
AA	DROP Int	GIVEN	\$30,140.81	\$42,952.99	\$120,480.91	\$8,185.35					
AB	DROP Balance	= Z + AA	\$339,915.90	\$404,496.00	\$685,093.74	\$141,836.82					
AC	DROP Annuity Payment	Calculated	\$31,759.96	\$41,198.81	\$68,394.45	\$12,970.71	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AD	Applicable Rollover	GIVEN	NO	YES	NO	YES	NO	NO	NO	YES	NO
AE	Pre-Tax Rollover	GIVEN	\$0.00	\$75,241.31	\$0.00	\$180,811.87	\$0.00	\$95,681.27	\$0.00	\$62,492.30	\$0.00
AF	Post Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$0.00	\$75,241.31	\$0.00	\$180,811.87	\$0.00	\$95,681.27	\$0.00	\$62,492.30	\$0.00
AH	Annuitized Rollover	Calculated	\$0.00	\$5,028.81	\$0.00	\$17,373.64	\$0.00	\$0.00	\$0.00	\$5,422.58	\$0.00
AI	Spouse Is Benef	GIVEN	YES	YES	YES	#N/A	YES	YES	#N/A	YES	NO
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	17.56%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$16,899.53
AL	Corbett Settlement	Calculated	\$7,208.15	\$0.00	\$0.00	\$5,370.57	\$4,436.58	\$0.00	\$7,915.58	\$0.00	\$0.00
AM	13th Check	Calculated	\$1,072.20	\$1,138.72	\$790.20	\$1,011.90	\$932.70	\$764.10	\$1,049.10	\$1,205.90	\$768.33
AN											
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$143,613.87	\$138,172.60	\$168,744.21	\$78,702.02	\$68,746.96	\$91,646.70	\$122,044.40	\$76,213.24	\$105,880.34
AP	415 Limit	Calculated	\$130,000.00	\$129,990.90	\$180,000.00	\$75,000.00	\$66,000.00	\$89,190.81	\$120,000.00	\$75,000.00	\$104,337.01
AO	Ratio	= AO / AP	1.10	1.05	1.05	1.05	1.04	1.03	1.02	1.02	1.01

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

			28	29	30	31	32	33	34	35	36
A	Ratio	= AO / AP	1.01	1.01	0.99	0.99	0.99	0.99	0.99	0.98	0.96
B	SSN	GIVEN									
C	FName	GIVEN									
D	LName	GIVEN									
E	Date of Birth	GIVEN	12/1/1943	8/1/1941	7/10/1948	9/28/1950	3/2/1948	1/22/1951	4/1/1933	6/28/1947	9/29/1947
F	Gender	GIVEN	M	M	M	M	M	M	M	F	M
G	Age at Ret	Calculated	57	57	57	55	59	55	65	55	58
H	Soc Sec NRA	Calculated	66	66	66	66	66	66	65	66	68
I	Date of Retirement	GIVEN	7/6/2000	12/31/1997	12/31/2005	9/28/2005	4/22/2004	12/31/2005	10/4/1997	8/28/2002	5/25/2003
J	Total Service	GIVEN	32.25	27.32	37.33	34.36	36.00	31.89	31.00	40.66	33.51
K	Plan ID	GIVEN	2	11	2	2	2	5	11	11	2
L	Safety Svc > 15 years	GIVEN	NO	NO	NO	NO	NO	YES	NO	NO	NO
M	Ben Type	GIVEN	SRET	SRET	DROPC	SRET	SRET	DROPC	SRET	SRET	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	100	50	80	50	50	50	50
P	Ben DOB	GIVEN	11/15/1943	9/15/1941	9/28/1948	4/1/1954	1/18/1947	10/6/1957	6/15/1928	10/30/1940	12/5/1946
Q	Age Difference	Calculated	0	0	0	4	2	7	-5	-1	-1
R	415 Annuity	GIVEN	\$10,319.28	\$8,960.12	\$8,923.84	\$16,478.16	\$16,623.48	\$11,999.88	\$11,999.88	\$9,667.92	\$13,368.80
S	415 Pension	GIVEN	\$60,250.44	\$62,864.88	\$72,119.88	\$73,386.12	\$100,903.68	\$96,848.28	\$102,311.40	\$68,722.92	\$78,832.64
T	415 Base Amt	= R + S	\$70,569.72	\$69,825.00	\$80,943.72	\$89,864.28	\$117,527.16	\$108,848.16	\$114,311.28	\$78,390.84	\$90,199.44
U	DROP Annuity Elected	GIVEN	YES	NO	YES	NO	YES	YES	NO	NO	NO
V	DROP Annuity Option	GIVEN	Life Expectancy		240 Months		240 Months	Life Expectancy			
W	Annuity Effective Date	GIVEN	1/1/2006		1/1/2006		1/1/2006	1/1/2006			
X	n-years	Calculated	27.9	1	20	1	20	29.6	1	1	1
Y	DROP Retirement Date	GIVEN	7/6/2000		12/31/2005		4/23/2004	12/31/2005			
Z	DROP Cont	GIVEN	\$111,243.50		\$226,302.11		\$116,198.17	\$560,829.81			
AA	DROP Int	GIVEN	\$6,758.43		\$23,328.66		\$3,711.88	\$111,550.32			
AB	DROP Balance	= Z + AA	\$118,001.93		\$248,630.77		\$119,910.05	\$672,380.33			
AC	DROP Annuity Payment	Calculated	\$10,688.69	\$0.00	\$25,323.59	\$0.00	\$12,213.10	\$59,932.57	\$0.00	\$0.00	\$0.00
AD	Applicable Rollover	GIVEN	YES	NO	YES	YES	YES	YES	NO	NO	YES
AE	Pre-Tax Rollover	GIVEN	\$67,840.92	\$0.00	\$58,410.22	\$73,360.56	\$136,524.69	\$32,560.82	\$0.00	\$32,334.08	\$79,849.08
AF	Post Tax Rollover	GIVEN	\$532.55	\$0.00	\$0.00	\$0.00	\$146.12	\$0.00	\$20,367.79	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$68,373.47	\$0.00	\$58,410.22	\$73,360.56	\$136,672.21	\$32,560.82	\$20,367.79	\$32,334.08	\$79,849.08
AH	Annuitized Rollover	Calculated	\$6,181.89	\$0.00	\$3,661.30	\$4,744.54	\$9,491.92	\$2,082.64	\$0.00	\$0.00	\$5,344.13
AI	Spouse is Bene	GIVEN	YES	YES	YES	YES	YES	YES	YES	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$4,887.75	\$0.00	\$0.00	\$0.00	\$0.00	\$8,001.79	\$0.00	\$0.00
AM	13th Check	Calculated	\$967.50	\$819.60	\$1,119.88	\$730.80	\$1,080.00	\$960.70	\$930.00	\$1,201.77	\$1,008.34
AN											
AO	Total Annual Compensation	= T + AC + AK + AL + AM + AH	\$76,044.23	\$75,532.35	\$103,725.89	\$85,860.54	\$121,328.34	\$167,654.79	\$129,243.07	\$79,592.61	\$85,863.65
AP	415 Limit	Calculated	\$75,000.00	\$75,000.00	\$104,337.01	\$86,642.50	\$122,562.85	\$170,000.00	\$129,000.00	\$80,917.50	\$89,432.92
AQ	Ratio	= AO / AP	1.01	1.01	0.99	0.99	0.99	0.99	0.98	0.98	0.96

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

		37	38	39	40	41	42	43	44	45
A	Ratio	= AO / AP	0.96	0.95	0.95	0.95	0.93	0.93	0.92	0.92
B	SSN	GIVEN								
C	FName	GIVEN								
D	LName	GIVEN								
E	Date of Birth	GIVEN	3/1/1947	11/1/1944	6/3/1945	1/12/1948	7/1/1933	5/21/1945	6/8/1950	4/8/1947
F	Gender	GIVEN	M	M	F	M	M	M	M	M
G	Age at Ref	Calculated	55	51	59	59	63	55	55	59
H	Soc Sec NRA	Calculated	66	66	66	66	65	66	66	66
I	Date of Retirement	GIVEN	7/24/2002	11/9/1995	4/22/2004	7/17/2004	1/9/1998	5/21/2000	9/16/2005	1/28/2006
J	Total Service	GIVEN	35.81	29.53	37.92	24.76	34.57	31.41	32.33	34.32
K	Plan ID	GIVEN	2	4	2	2	11	2	2	2
L	Safety Svc > 15 years	GIVEN	NO	YES	NO	NO	NO	NO	NO	NO
M	Ben Type	GIVEN	SRET	SRET	SRET	SRET	SRET	SRET	DROPC	DROPC
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	SLIFE	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	50	50	0	50	100	50
P	Ben DOB	GIVEN	5/15/1950	3/15/1961	7/19/1943	6/27/1946		8/15/1956	6/3/1951	6/9/1949
Q	Age Difference	Calculated	3	16	-2	0		11	1	2
R	415 Annuity	GIVEN	\$12,853.44	\$8,367.72	\$10,947.24	\$28,495.92	\$9,949.32	\$11,999.88	\$12,001.80	\$12,084.72
S	415 Pension	GIVEN	\$68,562.80	\$49,657.56	\$61,893.60	\$77,392.68	\$79,910.40	\$81,436.40	\$69,511.32	\$77,760.96
T	415 Base Amt	= R + S	\$82,416.24	\$58,025.28	\$102,840.84	\$105,888.60	\$89,859.72	\$73,436.28	\$81,513.12	\$89,845.68
U	DROP Annuity Elected	GIVEN	NO	NO	NO	NO	NO	NO	YES	NO
V	DROP Annuity Option	GIVEN			Grandfathered	Grandfathered		n Life Expectancy		Life Expectancy
W	Annuity Effective Date	GIVEN						1/1/2006		1/1/2006
X	n-years	Calculated	1	1	26.1	26.1	1	1	1	1
Y	DROP Retirement Date	GIVEN			4/22/2004	7/17/2004		9/16/2005	1/28/2006	11/18/2005
Z	DROP Cont	GIVEN			\$172,799.08	\$224,547.65		\$24,868.81	\$314,612.26	\$410,343.30
AA	DROP Int	GIVEN			\$10,024.64	\$15,760.67		\$1.72	\$39,786.13	\$64,846.47
AB	DROP Balance	= Z + AA			\$183,823.72	\$240,308.32		\$24,810.53	\$353,401.39	\$464,989.77
AC	DROP Annuity Payment	Calculated	\$0.00	\$0.00	\$16,984.65	\$22,203.62	\$0.00	\$0.00	\$2,250.08	\$34,074.93
AD	Applicable Rollover	GIVEN	YES	NO	YES	YES	NO	YES	YES	YES
AE	Pre-Tax Rollover	GIVEN	\$69,487.82	\$0.00	\$60,677.38	\$176,644.47	\$0.00	\$116,915.25	\$81,375.84	\$76,066.72
AF	Post-Tax Rollover	GIVEN	\$817.25	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$70,105.07	\$0.00	\$60,677.38	\$176,644.47	\$0.00	\$116,915.25	\$81,375.84	\$76,066.72
AH	Annuitized Rollover	Calculated	\$6,168.56	\$0.00	\$4,120.87	\$12,384.11	\$0.00	\$10,140.62	\$4,939.98	\$5,282.85
AI	Spouse is Bene	GIVEN	YES	YES	YES	YES	#N/A	YES	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$4,061.77	\$0.00	\$0.00	\$6,290.18	\$5,140.54	\$0.00	\$0.00
AM	13th Check	Calculated	\$1,104.19	\$885.90	\$1,137.54	\$742.70	\$1,040.10	\$942.30	\$969.81	\$1,029.53
AN										
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$77,351.87	\$62,972.95	\$118,842.15	\$116,450.81	\$97,190.00	\$69,378.50	\$79,793.03	\$119,667.39
AP	415 Limit	Calculated	\$90,917.50	\$68,000.00	\$122,562.85	\$122,562.85	\$104,090.00	\$75,000.00	\$86,642.50	\$129,990.90
AY	Ratio	= AO / AP	0.98	0.95	0.95	0.95	0.93	0.93	0.92	0.92

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

		46	47	48	49	50	51	52	53	54
A	Ratio	= AO / AP	0.90	0.89	0.89	0.88	0.88	0.88	0.87	0.86
B	SSN	GIVEN								
C	FName	GIVEN								
D	LName	GIVEN								
E	Date of Birth	GIVEN	11/1/1935	9/23/1949	1/1/1943	3/25/1950	3/24/1949	9/1/1939	3/18/1950	7/1/1941
F	Gender	GIVEN	F	M	M	M	M	M	M	M
G	Age at Ret	Calculated	61	55	55	55	55	57	55	56
H	Soc Sec NRA	Calculated	65	66	66	66	66	66	66	66
I	Date of Retirement	GIVEN	2/25/1997	1/29/2005	2/3/1998	9/2/2005	5/1/2004	9/10/1996	8/1/2005	4/1/1997
J	Total Service	GIVEN	45.77	30.88	36.74	28.43	29.17	31.54	43.69	28.07
K	Plan ID	GIVEN	2	2	4	4	4	4	2	2
L	Safety Svc >15 years	GIVEN	NO	NO	YES	NO	YES	NO	NO	NO
M	Ben Type	GIVEN	SRET	SRET	SRET	DROPC	SRET	SRET	DROPC	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	50	100	50	50	50	50
P	Ben DOB	GIVEN	9/15/1928	8/20/1953	10/15/1942	4/15/1949	5/12/1955	5/15/1942	4/10/1954	11/15/1941
Q	Age Difference	Calculated	-7	4	0	-1	6	3	4	0
R	415 Annuity	GIVEN	\$10,906.20	\$12,025.32	\$11,468.16	\$9,864.00	\$10,567.68	\$10,761.84	\$15,729.00	\$7,287.20
S	415 Pension	GIVEN	\$63,736.32	\$81,842.72	\$87,749.84	\$82,060.80	\$88,986.96	\$39,340.92	\$69,623.40	\$54,653.76
T	415 Base Amt	= R + S	\$74,642.52	\$73,868.04	\$99,217.80	\$91,924.80	\$99,554.64	\$50,102.76	\$75,352.40	\$61,950.96
U	DROP Annuity Elected	GIVEN	NO	NO	NO	YES	NO	NO	YES	NO
V	DROP Annuity Option	GIVEN		Grandfathered	Grandfathered	Life Expectancy	Grandfathered		240 Months	240 Months
W	Annuity Effective Date	GIVEN				1/1/2006			1/1/2006	
X	n-years	Calculated	1	29.6	29.6	29.6	29.6	1	20	1
Y	DROP Retirement Date	GIVEN		1/29/2005	2/3/1998	9/2/2005	5/1/2004		8/1/2005	1/1/2006
Z	DROP Cont	GIVEN		\$29,365.34	\$92,041.87	\$533,559.78	\$435,627.24		\$31,025.41	\$63,011.24
AA	DROP Int	GIVEN		\$231.39	\$2,487.92	\$110,535.14	\$89,017.44		\$240.02	\$1,804.05
AB	DROP Balance	= Z + AA		\$29,596.93	\$94,499.79	\$644,094.92	\$504,644.68		\$31,265.43	\$64,815.29
AC	DROP Annuity Payment	Calculated	\$0.00	\$2,638.12	\$8,423.23	\$57,411.35	\$44,981.48	\$0.00	\$3,184.45	\$0.00
AD	Applicable Rollover	GIVEN	NO	YES	NO	NO	NO	YES	YES	YES
AE	Pre-Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$72,288.67	\$21,630.43
AF	Post-Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$72,288.67	\$21,630.43
AH	Annuitized Rollover	Calculated	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$4,675.22	\$1,934.57
AI	Spouse Is Bene	GIVEN	YES	YES	YES	YES	YES	NO	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	7.19%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$3,603.35	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$5,224.98	\$0.00	\$6,545.25	\$0.00	\$0.00	\$3,507.19	\$0.00	\$4,336.57
AM	13th Check	Calculated	\$1,373.10	\$926.53	\$1,102.20	\$852.90	\$875.10	\$946.20	\$1,310.00	\$842.10
AN										
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$91,240.60	\$77,432.89	\$115,668.48	\$150,189.05	\$145,411.20	\$58,159.51	\$76,172.24	\$66,195.06
AP	415 Limit	Calculated	\$90,304.91	\$86,542.50	\$130,000.00	\$170,000.00	\$165,000.00	\$56,000.00	\$86,542.50	\$75,000.00
AQ	Ratio	= AO / AP	0.90	0.89	0.89	0.88	0.88	0.88	0.87	0.86

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

		55	56	57	58	59	60	61	62	63
A	Ratio	= AO / AP	0.85	0.84	0.84	0.84	0.84	0.83	0.82	0.81
B	SSN	GIVEN								
C	FName	GIVEN								
D	LName	GIVEN								
E	Date of Birth	GIVEN	6/1/1943	8/7/1946	7/1/1943	10/12/1949	12/13/1946	1/20/1945	10/30/1946	12/31/1944
F	Gender	GIVEN	M	M	M	M	F	M	F	M
G	Age at Ret	Calculated	59	58	52	55	56	60	57	57
H	Soc Sec NRA	Calculated	66	66	66	66	66	66	66	66
I	Date of Retirement	GIVEN	3/30/2002	6/5/2004	6/29/1995	10/13/2004	7/6/2002	9/1/2004	6/28/2003	1/9/2003
J	Total Service	GIVEN	35.50	28.67	29.17	27.90	39.80	25.88	25.34	25.33
K	Plan ID	GIVEN	4	4	4	2	2	4	2	11
L	Safety Svc >15 years	GIVEN	YES	YES	YES	NO	NO	YES	NO	NO
M	Ben Type	GIVEN	SRET	SRET	SRET	DEFER	SRET	SRET	SRET	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	50	50	50	50	50	50
P	Ben DOB	GIVEN	9/15/1949	9/28/1951	2/15/1945	9/18/1956	12/27/1938	12/26/1946	8/26/1941	12/15/1949
Q	Age Difference	Calculated	6	5	2	7	-8	2	-5	5
R	415 Annuity	GIVEN	\$10,188.48	\$10,438.68	\$7,938.12	\$25,000.44	\$9,333.48	\$10,352.88	\$14,279.52	\$2,186.04
S	415 Pension	GIVEN	\$73,131.00	\$83,200.88	\$43,304.88	\$55,844.04	\$69,002.76	\$75,171.60	\$89,987.84	\$95,654.64
T	415 Base Amt	= R + S	\$83,319.48	\$93,639.48	\$51,243.00	\$80,844.48	\$78,336.24	\$85,524.48	\$84,267.36	\$87,850.68
U	DROP Annuity Elected	GIVEN	YES	NO	NO	NO	NO	NO	NO	NO
V	DROP Annuity Option	GIVEN	Life Expectancy	Grandfathered				Grandfathered	Grandfathered	Grandfathered
W	Annuity Effective Date	GIVEN	1/1/2006							
X	n-years	Calculated	26.1	27	1	1	1	25.2	27.9	1
Y	DROP Retirement Date	GIVEN	3/30/2002	6/5/2004				9/1/2004	6/28/2003	6/30/1997
Z	DROP Cont	GIVEN	\$467,099.28	\$424,316.42				\$453,316.32	\$43,457.90	\$24,241.99
AA	DROP Int	GIVEN	\$88,972.87	\$65,599.43				\$84,412.16	\$184.67	\$242.41
AB	DROP Balance	= Z + AA	\$556,072.15	\$489,917.85				\$537,728.48	\$43,642.57	\$24,484.40
AC	DROP Annuity Payment	Calculated	\$51,379.05	\$44,802.05	\$0.00	\$0.00	\$0.00	\$60,242.53	\$3,953.17	\$0.00
AD	Applicable Rollover	GIVEN	NO	NO	NO	YES	YES	NO	YES	NO
AE	Pre-Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$172,762.75	\$58,106.64	\$0.00	\$126,090.11	\$0.00
AF	Post-Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AG	Total Rollover	= AE + AF	\$0.00	\$0.00	\$0.00	\$172,762.75	\$58,106.64	\$0.00	\$126,090.11	\$0.00
AH	Annuitized Rollover	Calculated	\$0.00	\$0.00	\$0.00	\$11,050.17	\$5,133.05	\$0.00	\$8,355.51	\$0.00
AI	Spouse is Bene	GIVEN	YES	YES	YES	YES	YES	YES	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$0.00	\$3,587.01	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AM	13th Check	Calculated	\$1,065.00	\$860.10	\$875.10	\$836.92	\$1,193.97	\$776.46	\$780.20	\$780.02
AN										
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$135,763.53	\$139,301.63	\$55,705.11	\$70,631.23	\$74,307.16	\$136,543.41	\$80,625.22	\$85,610.70
AP	415 Limit	Calculated	\$160,000.00	\$165,000.00	\$66,000.00	\$84,094.19	\$98,836.20	\$165,000.00	\$98,199.53	\$107,959.48
AO	Ratio	= AO / AP	0.85	0.84	0.84	0.84	0.84	0.83	0.82	0.81

**Exhibit K: Cheiron Retired 415 Test
Results -- SDCERS Retired 415 Test
Results**

		64	65	66	67	68	69	70	71	72
A	Ratio	= AO / AP	0.81	0.80	0.80	0.80	0.79	0.79	0.79	0.79
B	SSN	GIVEN								
C	FName	GIVEN								
D	LName	GIVEN								
E	Date of Birth	GIVEN	11/17/1946	1/1/1946	5/13/1947	12/1/1941	3/9/1953	6/15/1945	9/25/1947	1/19/1947
F	Gender	GIVEN	M	M	M	M	M	F	M	M
G	Age at Ret	Calculated	56	56	56	61	53	59	58	56
H	Soc Sec NRA	Calculated	66	65	66	65	66	66	66	66
I	Date of Retirement	GIVEN	11/23/2002	2/6/2004	6/29/2005	12/31/2002	10/5/2005	2/6/2004	6/7/2005	7/10/2003
J	Total Service	GIVEN	30.50	30.19	31.62	36.48	30.01	31.59	25.32	39.87
K	Plan ID	GIVEN	5	4	4	5	4	4	2	2
L	Safety Svc > 15 years	GIVEN	YES	YES	YES	YES	YES	YES	NO	NO
M	Ben Type	GIVEN	SRET	SRET	SRET	SRET	DROPC	SRET	SRET	SRET
N	Ben Option	GIVEN	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV	JSURV
O	J&S %	GIVEN	50	50	50	50	50	50	50	50
P	Ben DOB	GIVEN	11/21/1944	7/23/1947	5/19/1949	9/15/1960	3/10/1953	1/16/1965	1/2/1962	12/26/1943
Q	Age Difference	Calculated	-2	2	2	20	0	20	4	-3
R	415 Annuity	GIVEN	\$11,999.88	\$11,847.20	\$11,892.80	\$11,999.88	\$14,394.60	\$11,080.44	\$16,472.64	\$13,880.24
S	415 Pension	GIVEN	\$70,550.52	\$69,791.16	\$70,788.36	\$65,726.52	\$89,744.40	\$67,687.44	\$78,548.60	\$57,723.00
T	415 Base Amt	= R + S	\$82,550.40	\$81,438.36	\$82,680.96	\$77,726.40	\$104,139.00	\$78,767.88	\$95,019.24	\$71,583.24
U	DROP Annuity Elected	GIVEN	YES	NO	YES	NO	YES	NO	NO	NO
V	DROP Annuity Option	GIVEN	240 Months	Grandfathered	Life Expectancy	Grandfathered	240 Months	Grandfathered		Grandfathered
W	Annuity Effective Date	GIVEN	1/1/2006		1/1/2006		1/1/2006			
X	n-years	Calculated	29	27	27	24.4	20	28.1	1	28.7
Y	DROP Retirement Date	GIVEN	11/23/2002	2/6/2004	6/29/2005	12/31/2002	10/5/2005	2/6/2004		7/10/2003
Z	DROP Cont	GIVEN	\$424,768.35	\$469,741.28	\$482,572.89	\$439,370.51	\$296,824.35	\$449,905.04		\$41,762.40
AA	DROP Int	GIVEN	\$74,317.35	\$88,633.81	\$96,354.02	\$94,986.77	\$30,522.55	\$94,681.88		\$752.95
AB	DROP Balance	= Z + AA	\$499,085.70	\$558,375.09	\$578,926.91	\$534,357.28	\$327,746.90	\$544,586.90		\$42,526.35
AC	DROP Annuity Payment	Calculated	\$50,832.98	\$51,976.82	\$52,941.76	\$50,485.73	\$33,381.75	\$80,317.86	\$0.00	\$3,821.89
AD	Applicable Rollover	GIVEN	YES	YES	NO	YES	YES	NO	YES	YES
AE	Pre-Tax Rollover	GIVEN	\$59,717.40	\$22,469.17	\$0.00	\$12,247.55	\$57,786.59	\$0.00	\$80,220.80	\$91,240.89
AF	Post-Tax Rollover	GIVEN	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$2,816.44	\$0.00
AG	Total Rollover	= AE + AF	\$59,717.40	\$22,469.17	\$0.00	\$12,247.55	\$57,786.59	\$0.00	\$83,037.24	\$91,240.89
AH	Annuitized Rollover	Calculated	\$5,365.37	\$1,534.12	\$0.00	\$1,105.60	\$3,687.74	\$0.00	\$5,446.12	\$8,154.11
AI	Spouse is Benef	GIVEN	YES	YES	YES	YES	YES	YES	YES	YES
AJ	J&S % Adjustment	Calculated	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
AK	J&S Adjusted Amount	= AJ * T	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AL	Corbett Settlement	Calculated	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
AM	13th Check	Calculated	\$915.00	\$905.70	\$948.60	\$1,094.40	\$900.35	\$947.70	\$759.54	\$1,165.96
AN										
AO	Total Annual Compensation	= T + AC + AK + AL + AM - AH	\$128,933.01	\$132,786.76	\$136,571.32	\$128,180.93	\$134,733.35	\$130,033.44	\$90,332.66	\$70,416.97
AP	415 Limit	Calculated	\$160,000.00	\$165,000.00	\$170,000.00	\$160,000.00	\$170,000.00	\$165,000.00	\$114,706.94	\$89,433.92
AQ	Ratio	= AO / AP	0.81	0.80	0.80	0.80	0.79	0.79	0.79	0.79

Exhibit L

SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM

AUTHORIZATION FOR PRE-TAX BI-WEEKLY PAYROLL DEDUCTIONS
FOR PURCHASE OF SERVICE CREDITS

Member name:

SSN:

Type of Purchase: 5 YEAR (1.10365 YEARS)

Please initial next to each statement:

_____ I hereby authorize the City of San Diego to deduct **\$303.70** bi-weekly for **71** pay periods, by pre-tax payroll deduction for transfer to the San Diego Employees' Retirement System. This amount is in addition to my regular bi-weekly retirement contribution and is for the purpose of purchasing additional creditable service in the Retirement System.

_____ I understand that this pre-tax deduction cannot be changed or altered and must be completed as agreed under the terms of the pay plan until the balance, including interest is paid in full.

_____ I understand that I must adhere to the terms of this contract and that I cannot payoff the balance early in order to enter DROP.

In accordance with provisions of Retirement Board Rule 10.50 (a), if you are unable to complete the purchase due to death or disability retirement, you or your beneficiary may either pay off the remaining balance on the contract, if allowed by the IRS regulations, or receive a refund of the amount paid to date, net of any credit received for employee contribution rate roll backs.

Signature

Date

SSN

Exhibit 4

SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM
STAFF REPORT
FINANCE AND ADMINISTRATION DIVISION

DATE: February 7, 2007

TO: Board of Administration

FROM: Bob Wilson, Chief Financial Officer 

SUBJECT: Fiscal Year 2008 Preservation of Benefit Plan Funding

Recommendation

Request the City of San Diego to fund its Preservation of Benefits Plan in the amount of \$639,962 for its projected payments during calendar year 2007 for benefits due to its plan retirees that exceed IRC Code Section 415(b) limits.

Background

In August 2006, Ice Miller, tax counsel for SDCERS, submitted a report to the Internal Revenue Service under the Voluntary Compliance Program (VCP) covering Internal Revenue Code Section 415(b) compliance. This section establishes maximum allowable annual benefits that can be paid from a qualified 401(a) trust.

During the fall of 2006, SDCERS staff worked with Cheiron and Linea Solutions and developed comprehensive tests of the retired SDCERS members to identify those members who will receive plan benefits that exceed the IRS 415(b) limit. Allowable plan benefits that exceed the limits must be paid from IRC 415(m) plan. San Diego Municipal Code Chapter 2, Article 4, Division 16 establishes authority for the 415(m) plan, known as the "Preservation of Benefits" (POB) Plan.

Under the VCP filing with the IRS, SDCERS is establishing the administrative practices to pay benefits from the POB plans for our plan sponsors. Benefits will typically be payable in the second half of each calendar year for the amount of the excess benefits due to retirees.

As of February 7, 2007, a total of 18 retirees from the City of San Diego are projected to receive excess benefits totaling \$439,962 payable through December 31, 2007. New active members who file for retirement and begin receiving benefit payments during 2007 could also exceed their limits. (New retirees commencing January 1, 2007 are tested immediately upon filing for retirement benefits.) Staff believes it is prudent to request the City of San Diego to plan for funding an additional \$200,000, for a total of \$639,962 in POB funding in its fiscal year 2008 budget for members who may retire during 2007.

The San Diego Unified Port District and the San Diego Regional Airport Authority have no tested plan failures.

Staff has met with the chief fiscal staff of each of the three plan sponsors to inform them on the POB plans and funding arrangements for their fiscal year 2008 budget planning. The POB plan anticipates that plan sponsors will fund their annual requirement in advance of the projected time in which payments will begin.

Exhibit 5

policies, procedures, and internal controls regarding i) its financial and other disclosures, ii) the hiring of internal personnel and external experts for disclosure functions, and iii) the implementation of active and ongoing training programs to educate appropriate City employees regarding compliance with disclosure obligations, and to provide conclusions and recommendations with respect to these matters.

Additionally, the Independent Consultant's Report recognizes the complexity of the City's issues and includes numerous actions that are planned to be addressed in the future, including:

- Ongoing analysis and observation by the Independent Consultant of the City's disclosure process, including participation in future offering disclosure processes,
- Implementation of a new Enterprise Resource Planning (ERP) system,
- Ongoing training for the City Council, City Officials, and City employees, and
- Hiring a qualified internal auditor to provide reliability of the City's internal control structure.

The Independent Consultant observed that the City had made progress with its remediation efforts, but that there is much left to be done that will require an intensive and substantial effort.

On July 23, 2007, the SEC issued a letter to the City and to the Independent Consultant recognizing the recommendations outlined in the Independent Consultant's Report and indicating its understanding that subsequent reports from the Independent Consultant would provide more complete, specific, and concrete recommendations with specific deadlines. The SEC also requested a response from the City in regards to the recommendations outlined in the Independent Consultant's Report, including an estimated timeframe for implementation of the recommendations.

On September 25, 2007 the City responded to the SEC, this response was approved by the Council Resolution No. 303021. This response to the SEC is summarized as follows:

- The CFO, along with representatives of the Audit Committee and the Independent Budget Analyst, interviewed candidates for the Internal Auditor. The candidate selected began work on October 22, 2007. The Charter Review Committee is also looking into a Charter change which would separate the internal audit function from the comptroller and management duties. This revision will need to be approved by a vote of the public.
- The City has established an Audit Committee comprised of 3 Council members and an ad hoc committee of 3 outside advisors who bring extensive technical expertise to the Committee. The ad hoc committee began serving September 10, 2007. The Charter Review Committee is also looking into a Charter change which would formally establish the composition of the Audit Committee. This revision will need to be approved by a vote of the public.
- The City has selected a software vendor for an enterprise resource system. The current schedule calls for the implementation of a new core system by October 2008, followed by the implementation of the human resource/payroll system by January 2009.
- The CFO position was established in calendar year 2006 and all financial related activities and responsibilities of the City fall under this position.
- The City is carefully evaluating the Independent Consultant's recommendation to consider moving toward a shelf-like disclosure system. The City has made many improvements to internal controls regarding the release of financial information to the public capital markets (e.g. creation of the DPWG, CFO, and Audit Committee). Accordingly, any shelf-like registration would take into consideration procedures currently in place which were designed to ensure that the City would not make misleading statements or omissions to the market place in the future.

Financial Information

Pension Benefits

In fiscal year 1927, the City established the San Diego City Employees' Retirement System ("SDCERS"), a public employee retirement system. The pension plan ("Plan") is a defined benefit plan and is administered by the SDCERS' Board to provide retirement, disability, death, and survivor benefits for its members. The SDCERS Board contracts with an actuary to perform an annual actuarial valuation based on the assumptions adopted by the SDCERS Board. A new actuarial firm, Cheiron Inc., was hired by the SDCERS board to perform the 2005 and 2006 actuarial reports.

The actuarial valuations performed by Cheiron for the fiscal years ended June 30, 2006 and June 30, 2005 reported as follows:

San Diego City Employees' Retirement System (City of San Diego)

	Fiscal Year Ended		
	June 30, 2006	June 30, 2005	% Change
<u>Membership</u>			
Total Members (active, disabled, beneficiaries and retired)	17,647	17,429	1.3%
<u>Assets and Liabilities</u>			
Total Actuarial Liability	\$ 4,982,699,455	\$ 4,377,092,948	13.8%
Market Value of Assets	3,981,931,694	3,205,721,975	24.2%
Actuarial Value of Assets	3,981,931,694	2,983,079,852	33.5%
Unfunded Actuarial Liability	\$ 1,000,767,761	\$ 1,394,013,096	(28.2%)
Funding Ratio	79.9%	68.2%	11.7%

It is common practice to base consecutive actuarial valuations on consistent pre-defined parameters; however, occasional methodology changes are required to reflect prevailing practices within the industry. The actuarial methodology changes with the most significant impact to the unfunded actuarial liability between fiscal years 2005 and 2006 are related to the inclusion of certain "contingent" liabilities in the valuation and a change in the asset smoothing method, both of which are discussed in detail below.

The actuarial valuation information presented above for the fiscal year ended June 30, 2005 is based upon historical assumptions in regards to some benefits being viewed as contingent in nature, and therefore, does not include information on liabilities pertaining to the Corbett Settlement or the 13th Check, both of which were included as liabilities in the fiscal year 2006 valuation. Additionally, SDCERS has established reserves of assets in an amount approximately equivalent to the related liability for the following items: Supplemental Cost of Living Adjustment, Employee Contribution Rate Increase Liability, and the Deferred Retirement Option Plan Liability. The assets placed in these reserves, as well as the corresponding liability, have also been excluded from the fiscal year 2005 actuarial valuation.

For the benefit of the reader, the following table presents the balances of all liabilities excluded from the actuarial valuation for the fiscal year ended June 30, 2005:

SDCERS Other Liabilities

Corbett Settlement	\$ 58,923,978
13th Check	56,686,313
Supplemental Cost of Living Adjustment *	17,839,967
Employee Contribution Rate Increase Liability *	8,905,418
Deferred Retirement Option Plan Liability *	227,223,791
Total Other Liabilities	<u>\$ 369,579,467</u>

* SDCERS has established reserves of assets approximately equivalent to related liability.

A detailed explanation of the liabilities and their related assets can be found in the actuarial valuations for fiscal year 2005 and fiscal year 2006 which can be obtained at the SDCERS main office located at 401 West A Street, Suite 400, San Diego, CA 92101.

For the purposes of calculating the City's net pension obligation (NPO), calculated amounts include the effects from the Corbett settlement liability and the employee contribution rate increase liability due to the City's position that these liabilities are non-contingent in nature. As such, the following schedule shows the City's view of its revised unfunded actuarial liability as of June 30, 2005 and presents a comparison to the fiscal year 2006 valuation. The employee contribution rate increase liability and its

corresponding asset reserve are not included in the revised calculation as of June 30, 2005 due to its immaterial effect on the unfunded actuarial liability. Additionally, the City views the liabilities related to the 13th check as contingent in nature, and therefore, excluded them from the revised calculation of the City's unfunded actuarial liability.

Calculation of City's Unfunded Actuarial Liability

	Fiscal Year Ended		% Change
	June 30, 2006	(revised)*** 6/30/2005	
Actuarial Liability (Cheiron*)	\$ 4,982,699,455	\$ 4,377,092,948	
Corbett Settlement (Cheiron*)	n/a **	58,923,978	
Total Actuarial Liability	4,982,699,455	4,436,016,926	12.3%
Actuarial Value of Assets (Cheiron*)	3,981,931,694	2,983,079,852	33.5%
Unfunded Actuarial Liability****	\$ 1,000,767,761	\$ 1,452,937,074	(31.1%)
Funding Ratio	79.9%	67.2%	12.7%

* SDCERS Actuary

** Liabilities related to the Corbett Settlement and the 13th Check are included in actuarial liabilities in fiscal year 2006.

*** As discussed in the narrative, the City believes the liability related to the Corbett Settlement should be included in total actuarial liabilities.

**** Unfunded Actuarial Liability has been calculated in accordance with the projected unit credit (PUC) method, see table on page 21 for comparison to entry age normal (EAN) method.

As a result of the approval of revised assumptions and methodologies on October 20, 2006 by the SDCERS Board of Administration, the actuarial valuation for the fiscal year ended June 30, 2006 includes the liabilities resulting from the Corbett Settlement and the 13th Check as well as both the asset reserves and the corresponding liabilities related to the Deferred Retirement Option Plan and the Supplemental Cost of Living Adjustment. The recognition of these previously excluded liabilities increased actuarial liabilities in the valuation dated June 30, 2006 by approximately \$113 million over amounts reported in fiscal year 2005.

As previously stated, the City views the exclusion of the Corbett Liability from the Actuarial Liability as inappropriate and therefore has already restated its Net Pension Obligation and amended its required supplementary schedules accordingly. The City views the SDCERS Board of Administration's decision regarding the 13th Check liability as a change in accounting estimate and therefore will account for it prospectively beginning with its fiscal year 2007 financial statements. This treatment reflects City management's policy of valuing and reporting pension liabilities using the actuarial valuation from the fiscal year ending one year prior to the date of its financial statements. Additionally, total actuarial assets, total actuarial liabilities, and the funding ratio increased in fiscal year 2006 partially due to the inclusion of the asset reserves and liabilities related to the Deferred Retirement Option Plan and the Supplemental Cost of Living Adjustment.

In addition to the inclusion of the aforementioned assets and liabilities in the June 30, 2006 valuation, the SDCERS Board of Administration voted to move from a "book value based" asset smoothing method to the "expected asset value" smoothing method. The expected asset value smoothing method is based on asset market value and is a more commonly used practice in actuarial valuations because it is a more effective technique to dampen the volatility in asset values that can occur due to fluctuations in market conditions. A part of this change was to set the actuarial value of assets equal to the market value of assets as of June 30, 2006. This action increased the actuarial value of assets from the amounts reported in the fiscal year 2005 valuation by approximately \$184 million. SDCERS also changed the manner in which assets are apportioned between plan sponsors, which also resulted in increasing the actuarial value of assets in the City's plan. The following schedule shows the effect of the specific components of the total change of the Unfunded Actuarial Liability between fiscal years 2005 and 2006:

SDCERS - City of San Diego
Source of Changes in Unfunded Actuarial Liability

(In Millions)

Experience

1. UAL change due to investment experience	\$ (158.9)
2. UAL change due to purchased service credit	1.2
3. UAL change due to overall liability gain	(47.5)

Contributions

4. UAL change due to contributions in excess of expected	(105.6)
--	---------

Actuarial

5. UAL change due to marking the smoothing method to market value	(183.8)
6. UAL change due to reflection of "contingent" liabilities	112.7
7. UAL change due to DROP and supplemental COLA	-
8. UAL change due to removal of liabilities in excess of IRC § 415 limits	(22.8)
9. UAL change due to removal of future disability benefits	(9.9)

Total

10. Total net overall experience: sum 1 through 9	(414.6)
11. Expected change in UAL	21.4
12. Total change in UAL: 10 + 11	<u>\$ (393.2)</u>

The benefits awarded to some plan participants exceed the amount permitted for Internal Revenue Code (IRC) 401(a) pension plans such as SDCERS. In March 2001, the San Diego City Council established a Preservation of Benefit Plan to pay for benefits in excess of those allowed under the 401(a) plan. The Preservation of Benefit Plan is a qualified governmental excess benefit arrangement (QEBA) under IRC § 415(m), which is a vehicle created by Congress to allow the payment of promised pension benefits that exceed the IRC § 415(b) limits (and therefore cannot be paid from a qualified retirement plan). The Preservation of Benefit Plan is administered by the SDCERS Board separately from the City's 401(a) pension plan. On February 16, 2007, the SDCERS Board adopted the Preservation of Benefit Plan and Trust to carry out the intent of SDMC § 24.1601 et seq.

As background, IRC § 415(b) imposes dollar limits on the benefits payable from a qualified pension plan that receive favorable tax treatment. The dollar limit is \$175,000 for calendar year 2006; however, this limit is adjusted based upon the payee's age at retirement, and the benefit tested is adjusted by a number of factors.

The Preservation of Benefit Plan is unfunded within the meaning of the federal tax laws. Under the Internal Revenue Code the City may not pre-fund the Preservation of Benefit Plan to cover future liabilities beyond the current year, as with the 401(a) plan. Each year, SDCERS will determine the amount necessary to fund any pension benefits payable during the calendar year in excess of IRC § 415(b). This amount will include the projected amount of all excess pension benefits payable for the calendar year to existing and projected payees, as well as the projected cost of administering the Preservation of Benefit Plan. SDCERS will provide this information to the City and the City will fund this amount on an annual basis.

Any amounts remaining in the Preservation of Benefit Plan at the end of a calendar year will be carried forward to pay benefits and administration costs in the following year. As a result, the liability related to excess benefits for eligible active members of the system, amounting to approximately \$22.8 million, has been excluded from the actuarial valuation of the 401(a) retirement plan beginning in fiscal year 2006 (as shown in the table above). The estimated liabilities for retired members of the Preservation of Benefit Plan have not yet been provided to the City by SDCERS as a separate amount distinct from the City's core 401(a) pension plan. Accordingly, they are reflected in the actuarial liabilities of the 401(a) plan in the actuarial valuation dated June 30, 2006.

In fiscal year 2005, activities related to the Preservation of Benefit Plan for both retired and active members are included in the actuarial liabilities presented in the Required Supplementary Information (RSI) for the City's core pension plan and are valued using the same set of assumptions. In a review of the financial statements of other local governments, the City has noted significant diversity of practice in how governments are accounting for QBAs. As such, the City is in the process of implementing a plan to account for the QEBA with SDCERS.

Certain other methodology changes were implemented for the June 30, 2006 valuation, which are discussed in detail in the valuation report. Additional information on the City's net pension obligation, annually required contribution, and the Corbett liability is discussed in Note 12 of the notes to the financial statements contained in the financial section of the CAFR and in the Required Supplementary Information section of the report.

On November 2, 2004, the public approved an amendment to Article 9, Sections 143 and 144 of the City's Charter regarding the retirement systems actuarial assumptions and the governance structure of SDCERS. Notable changes include:

- Effective fiscal year 2009, Unfunded Actuarially Accrued Liability shall be amortized using a 15 year assumption; for the 2006 actuarial valuation, Unfunded Actuarial Accrued Liabilities were amortized over 27 years reflecting the resetting of the amortization period pursuant to the settlement of the Gleason v. City of San Diego lawsuit. (The effects of this lawsuit on the pension system are disclosed in Note 12).
- Effective fiscal year 2009, new retirement benefits shall be amortized using a schedule no longer than 5 years.
- Effective April 2005 the composition of the SDCERS Board was changed to the following:
 - 7 members appointed by the Mayor, who are not associated with the City or Retirement system as employees, union members or beneficiaries,
 - 1 member who is an active employee in the police safety group, elected by the members of that group,
 - 1 member who is an active employee in the fire safety group, elected by the members of that group,
 - 2 members who are active employees in the general member group, elected by members of that group,
 - 1 member who is a retired member of the system and is elected by the retired members of the system, and
 - 1 member who is a City management employee and serves at the pleasure of the Mayor. This member must be the Chief Operating Officer, City Treasurer, Deputy or Assistant Chief Operating Officer or a similar position that reports to the Chief Operating Officer or Mayor. As of the issuance of this report, the Deputy Chief of the Office of Ethics and Integrity is assuming the responsibility of this position.

A review of the aforementioned charter revisions concerning SDCERS is currently underway. This includes examining the legality of changes to the City's amortization assumption made by way of revisions to the City Charter. California State Attorney General Opinion 04-710 concludes that a city charter cannot mandate a specified amortization schedule for retirement benefits or accumulated actuarial gains and losses. Furthermore, a recent legal ruling by the California Superior Court concluded that SDCERS Board has "plenary authority" over the retirement system in its administrative capacity. In March 2007, the SDCERS Board adopted a 20 year amortization assumption. The SDCERS Board has not indicated whether it will change to a 15 year amortization assumption for the purpose of determining the City's fiscal year 2009 Annually Required Contribution. The San Diego City Attorney's Office has opined that the voter's amendment to the Charter to establish a 15-year amortization requirement for accumulated actuarial losses simply establishes an upper boundary for the amortization of pension debt, and does not usurp or unduly interfere with the SDCERS Board's plenary authority and fiduciary responsibility in violation of the California constitution, and as a result, the 15 year amortization period is binding. Given the size of the City's current Unfunded Actuarially Accrued Liability, a change to a 15-year amortization schedule will have a significant impact on future annually required contributions. In relation to the implementation of a 15-year amortization, SDCERS issued a report titled "Summary and Answers to Frequently-Asked Questions about the June 30, 2006 Actuarial Valuation for the City of San Diego." This document stated that if a 15-year amortization of the unfunded actuarial liability was implemented, the City's Annual Required Contribution for fiscal year 2008 would increase by \$29.1 million over the requested contribution of \$137.7 million. Thus, a 15-year amortization period would result in an Annual Required Contribution of \$166.8 million. Comparatively, the City's fiscal year 2008 budget includes appropriations for a contribution of \$165 million to SDCERS.

The City notes that Governmental Accounting Standards expressly state that "a plan and its employers should apply the same actuarial methods and assumptions in determining similar or related information included in their respective financial reports." However, the GASB does not assign responsibility for determining actuarial assumptions to either the plan administrator or the plan sponsor. As such, the City and SDCERS will need to reach a consensus regarding the actuarial assumptions to be used for the fiscal year 2007 actuarial valuation in advance of its performance.

Following the most widely used actuarial cost method approved in Statement No. 25 of the Governmental Accounting Standards Board, as well as a recommendation from Cheiron, SDCERS Board of Administration voted to use the entry age normal (EAN) actuarial cost method to calculate future actuarial liabilities beginning with the fiscal year 2007 valuation. Historically, the actuarial valuations performed for SDCERS have calculated actuarial liabilities in accordance with the projected unit credit (PUC) method. This change of methodology will negatively impact the unfunded actuarial liability reported in the actuarial valuation for the fiscal year ended June 30, 2007. A comparison of the two valuation methods for the fiscal year ended June 30, 2006 was included in the June 30, 2006 actuarial valuation and is provided on the following page for informational purposes only.

Unfunded Actuarial Liability
Projected Unit Credit (PUC) vs. Entry Age Normal (EAN)
For the Fiscal Year Ended June 30, 2006

	PUC	EAN	% Change
Actuarial Value of Liability (Cheiron*)	\$ 4,982,699,455	\$ 5,191,961,336	4.2%
Actuarial Value of Assets (Cheiron*)	3,981,931,694	3,981,931,694	0.0%
Unfunded Actuarial Liability	1,000,767,761	1,210,029,642	20.9%
Funding Ratio	79.9%	76.7%	(3.2%)

*SDCERS Actuary

On November 7, 2006, the public approved an amendment to Article 9, § 143 of the City's Charter, requiring voter approval of certain increases in retirement system benefits for public employees. Specifically, this amendment requires voter approval of any ordinance that amends the City's retirement system by increasing the benefits of any employee. However, increases in retirement benefits due to cost of living adjustments do not require voter approval.

On August 3, 2007, the General Counsel of SDCERS issued a letter to the City stating their opinion in regards to the effective date of the fiscal year 2005 agreements between the City and the labor unions. As part of the agreements, several benefits were altered or eliminated for employees hired on or after July 1, 2005, including the Deferred Retirement Option Plan (DROP), the 13th Check, and the option to purchase years of service credits ("air-time"). According to their fiduciary counsel, "SDCERS is obligated to administer benefits in accordance with its plan documents." However, the City did not enact such ordinances until January 17, 2007, which took effect on February 16, 2007. Therefore, the General Counsel of SDCERS and their outside counsel opine that the effective date of the agreements with the labor unions is February 16, 2007, the date that the benefit changes were codified into the plan document. On October 9, 2007, the City filed a petition for declaratory relief to determine the effective date of retirement benefit changes for employees hired between July 1, 2005 and February 16, 2007.

On September 21, 2007 the President of the SDCERS Board of Administration issued a press release stating that, under the direction of the Board of Administration, SDCERS' staff, actuary, and legal counsel, he had reviewed the SDCERS purchase of service credit program, and that his review concluded the following:

- With respect to SDCERS' service credit pricing structure that was in place prior to November 2003, Cheiron, SDCERS actuary, has determined that the full cost was not reflected in the price then charged to SDCERS members.
- This pricing shortfall, which totals approximately \$146 million, has been included in the System's Unfunded Actuarial Liability since the inception of the service credit program.
- With respect to the SDCERS' service credit pricing in place since November 2003, Cheiron advised SDCERS that structure covers the full projected cost to the System when members purchased the service credits.

The pricing shortfall of approximately \$146 million, which is included in the System's Unfunded Actuarial Liability, is reported in the RSI of these financial statements.

Additional information regarding the City's pension trust fund, including the City's NPO, can be found in Note 12 of the notes to the financial statements.

Other Post Employment Benefits

Retiree Health

The City provides certain healthcare insurance benefits to a variety of retired employees, as provided for in SDMC Sections 24.1201 through 24.1204 (the "Plan"). Currently, the benefits are primarily for employees who were actively employed on or after October 5, 1980 and were otherwise entitled to retirement allowances. Employees who retired or terminated prior to October 6, 1980, who were eligible for retirement allowances prior to that date, are also eligible for healthcare benefits, limited to a total of \$1,200 per year. Additionally, employees who were hired on or after July 1, 2005 and become eligible for retirement allowances

GENERAL MEMBER RETIREMENT CALCULATION FACTORS

Retirement Age	Unmodified Factors	Unmodified Factors	Unmodified Factors
	Effective 6/30/00 (Old Factors)	Effective 7/1/00 (Corbett Factors)	Effective 7/1/02 (New Factors)
55	2.00%	2.25%	2.50%
56	2.00%	2.25%	2.50%
57	2.00%	2.25%	2.50%
58	2.00%	2.25%	2.50%
59	2.08%	2.25%	2.50%
60	2.16%	2.30%	2.55%
61	2.24%	2.35%	2.60%
62	2.31%	2.40%	2.65%
63	2.39%	2.45%	2.70%
64	2.47%	2.50%	2.75%
65 and older	2.55%	2.55%	2.80%

SAFETY MEMBER RETIREMENT CALCULATION FACTORS

Retirement Age	Unmodified Factor*		Unmodified Factor*
	Effective 1/01/97 - 6/30/00		Effective 7/01/00
	Lifeguard	Police & Fire	
50	2.20%	2.50%	3.00%
51	2.32%	2.60%	3.00%
52	2.44%	2.70%	3.00%
53	2.57%	2.80%	3.00%
54	2.72%	2.90%	3.00%
55	2.77%	2.99%	3.00%

*Unmodified Factor utilized to calculate the maximum service retirement allowance.

Additionally, on March 19, 2001, the City Council adopted Ordinance O-18930, adding SDMC sections 24.1601 through 24.1608, establishing the Preservation of Benefit Plan (POB Plan). The POB Plan is a qualified governmental excess benefit arrangement (QEBA) under Internal Revenue Code (IRC) section 415(m), which was created by Congress to allow the payment of promised pension benefits that exceed the IRC section 415(b) limits (and therefore cannot be paid from a qualified retirement plan). The POB Plan is administered by the SDCERS Board as a separate trust from the City's pension plan. On February 16, 2007, the SDCERS Board adopted the Preservation of Benefit Plan and Trust to carry out the intent of SDMC section 24.1601 et seq. As provided, in SDMC section 24.1606, and required by federal tax law, the POB Plan is unfunded within the meaning of the federal tax laws. The City may not pre-fund the POB Plan to cover future liabilities beyond the current year as it can with an IRC section 401(a) pension plan, and is therefore in the process of establishing a mechanism to pay for these benefits on a pay-as-you-go basis. Currently, activities related to the POB Plan are included in the RSI for the City's pension plan using actuarial assumptions consistent with those used to perform actuarial valuations for the City's core pension plan.

On November 7, 2006, the citizens approved an amendment to Article 9, Section 143 of the City's Charter, requiring voter approval of certain increases in retirement system benefits for public employees. Specifically, this amendment requires a majority approval of any ordinance that amends the City's retirement system by increasing the benefits of any employee. However, increases in retirement benefits due to cost of living adjustments do not require voter approval.

Additional details of retirement benefits can be obtained from SDCERS. SDCERS is considered part of the City of San Diego's financial reporting entity and is reported as a pension trust fund. SDCERS issues stand-alone financial statements which are available at its office located at 401 West A Street, Suite 400, San Diego, California 92101.

b. **Summary of Significant Accounting Policies – Pension**

Basis of Accounting - The pension trust fund uses the economic resources measurement focus and the accrual basis of accounting. Contributions are recognized as additions in the period in which the contributions are due and a formal commitment to provide the contributions has been made. Benefits and refunds are recognized when due and payable in accordance with the Plan.

Method Used to Value Investments - SDCERS investments are stated at fair value. The SDCERS custodial agent provides market values of invested assets with the exception of the fair value of directly owned real estate assets which are provided by the responsible investment manager and independent third party appraisal firms. Investment income is recognized in accordance with GASB 25 and is stated net of investment management fees and related expenses.

c. **Contributions and Reserves - Disclosure Related to Long - Term Contracts and Other Agreements**

Funding Contracts: MP-1 and MP-2

The City employer contributions for fiscal years 1996 - 2003 were not based on the full actuarial rates. Instead, employer contributions were less than the full actuarial rates in accordance with an agreement between the City and SDCERS, commonly referred to as Manager's Proposal 1 (MP-1). MP-1 provided that the City would make annual payments according to a contractually fixed formula of slowly increasing percentages of total payroll instead of annual payments based on the annually required contribution (ARC) rates determined by the actuary. This agreement was subject to an actuarially determined funding ratio ("the trigger") of 82.3%. In the event the trigger was reached, the City would be required to make a lump sum payment to return the system to the funding ratio of 82.3%. The funding provision established by MP-1 was effective until fiscal year 2007, at which time, the City's contribution would return to the full ARC rate determined by the actuary. In the opinion of Kroll (a professional consulting firm engaged by the City to act in the capacity of an Audit Committee) and the City Attorney, the funding mechanism of MP-1 was illegal in violation of the City Charter and the State Constitution.

In 2002, a second agreement between the City and SDCERS was ratified; this agreement subsequently became known as Manager's Proposal 2 (MP-2). MP-2 modified MP-1 principally by allowing the City to avoid a balloon payment if the trigger was reached. Instead, MP-2 allowed the City to increase its funding until the full ARC was reached. This provision of MP-2 required that funding be increased over a five year period. In the opinion of Kroll and the City Attorney, the funding mechanism of MP-2 was illegal in violation of the City Charter and the State Constitution.

The actuarial valuation as of June 30, 2002, received in January 2003, which applies to contributions made in fiscal year 2004, stated the funded ratio to be 77.3%, thus the trigger had been breached. As a result, the City paid the increased contribution rates (which were less than the full actuarial rates) as required by MP-2 in the next fiscal year (fiscal year ended June 30, 2004). MP-1 and MP -2 are no longer in effect due to the Gleason settlement (see the section titled "Funding Commitments Related to Legal Settlements" in this Note).

A discussion of funding levels can be found in the Funding Policy and Annual Pension Cost section of this note.

Exhibit 6



JERRY SANDERS
MAYOR

October 26, 2007

Honorable City Council Members and the Citizens of the
City of San Diego, California

San Diego City Charter § 111 requires the City to submit an annual report, including a Statement of Net Assets, and requires that all accounts of the City be audited by an independent auditor. Pursuant to this requirement, the Comprehensive Annual Financial Report ("CAFR") of the City of San Diego ("City") for the fiscal year ended June 30, 2005, is hereby submitted. The audit firm of Macias Gini & O'Connell LLP has issued an unqualified opinion on the City of San Diego's financial statements. The independent auditor's report is located at the front of the financial section of this report.

The CAFR has been prepared in conformance with the principles and standards for reporting as set forth by the Governmental Accounting Standards Board (GASB). Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the management of the City and its related agencies. Our objective is to provide you with reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements. Additionally, the City continues to construct and improve a comprehensive internal control framework in order to ensure acceptable management of taxpayer funds.

To the best of our knowledge and belief, the data as presented, is accurate in all material respects; it is presented in a manner designed to present fairly the financial position and results of operations of the governmental activities, business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining funds of the City and its related agencies; and all disclosures necessary to enable the reader to gain an understanding of the City's, as well as its related agencies', financial activities have been included.

The City wishes to bring to the attention of the reader for careful consideration Notes 12, 13, and 18 to the Financial Statements, which address, among other matters, (1) the cease-and-desist order imposed on the City by the Securities and Exchange Commission for violations of the federal securities laws that occurred in 2002 and 2003, (2) related investigative reports of Kroll Inc. and the law offices of Willkie, Farr and Gallagher LLP, serving as the audit committee for the City of San Diego (Kroll Report), Navigant Consulting, Inc. (as it relates to San Diego City Employees Retirement System (SDCERS)), and the City Attorney of the City of San Diego, and (3) the unfunded actuarial accrued liabilities of the City's pension and retiree health obligations. These notes, along with the other financial and operational data included in the City's CAFR, must be read in their entirety to obtain a complete understanding of the City's financial position.

A narrative introduction, overview, and analysis of the financial statements can be found in Management's Discussion and Analysis (MD&A) which immediately follows the independent auditor's report. The MD&A complements this letter of transmittal and should be read in conjunction with it.

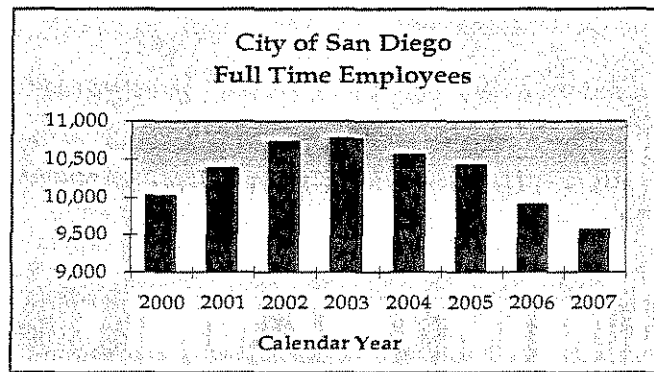
The CAFR is organized into three sections:

- **The introductory section** includes information about the organizational structure of the City, the City's economy, and selected other financial information.
- **The financial section** is prepared in accordance with Governmental Accounting Standards. It includes the MD&A, the independent auditor's report, the audited basic financial statements, notes to the basic financial statements, required supplementary information, and supporting statements and schedules.
- **The statistical section** contains historical statistical data on the City's financial data and debt statistics, as well as miscellaneous physical, demographic, economic, and social data of the City.

PROFILE OF THE GOVERNMENT

City Profile

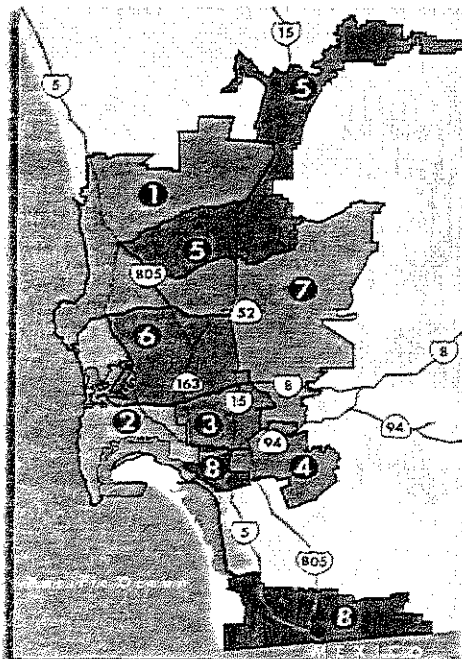
The City of San Diego was incorporated in 1850. The City is comprised of 403 square miles and, as of January 1, 2007, the California Department of Finance estimates the population to be 1,316,837. The City, with approximately 9,600 full-time employees, provides a full range of governmental services which include police and fire protection, sanitation and health services, the construction and maintenance of streets and infrastructure, recreational activities and cultural events, and the maintenance and operation of the water and sewer utilities.



Governing Structure

The City operates and is governed by the laws of the State of California and its own Charter which was adopted by the electorate in 1931 and has been subject to periodic amendments since adoption. During the period reported in this report, the City employed a Council-Manager form of government. Under this form of government, the City Council was comprised of eight members elected by district to serve overlapping four-year terms. The City Council, which acted as the City's legislative and policy-making body, appointed the City Manager, who was the City's chief administrator and was responsible for implementing the policies and programs adopted by the City Council. The Mayor, who presided over the City Council, was elected at large to serve a four-year term. In addition, the City has an elected City Attorney who is the chief legal advisor of and attorney for the City and all departments. The City Attorney serves a four-year term.

City of San Diego Council District Map



During the fiscal year ended June 30, 2005 and prior to the issuance of this CAFR, the electorate of the City of San Diego approved the strong-mayor form of government on a trial basis which took effect during the fiscal year ended June 30, 2006. The charter amendment adopting the strong-mayor form of government is in effect for five years, and pending a voter approved extension or modification, sunsets on December 31, 2010. Under the strong-mayor form of government, the Mayor is the Chief Executive Officer of the City and has direct oversight over all City functions and services except for the City Council, Personnel, City Clerk, Independent Budget Analyst (IBA), and City Attorney's departments. The Office of the Independent Budget Analyst was established by the City Council to assist the Council in the conduct of budgetary analysis and in the making of budgetary, financial, and policy decisions. Additionally, the City Council established a Budget and Finance Committee to aid in the review of the annual budget, capital improvement programs, financial reports, taxes, fees, assessments, and IBA reports.

Under this form of government, the Council is composed of eight members and is presided over by the Council President, who is selected by a majority vote of the Council. The Mayor presides over Council in closed session meetings of the Council. The Council retains its legislative authority; however, all council resolutions, except for appropriations ordinances, are subject to a veto of the Mayor. The City Council may override a Mayoral veto with five votes.

Current Elected Officials
(as of the issuance of this report)



Mayor Jerry Sanders

District 1
Council President Scott Peters



District 5
Councilmember Brian Maienschein



District 2
Councilmember Kevin Faulconer



District 6
Councilmember Donna Frye



District 3
Councilmember Toni Atkins



District 7
Councilmember Jim Madaffer



District 4
Council President Pro Tem
Tony Young

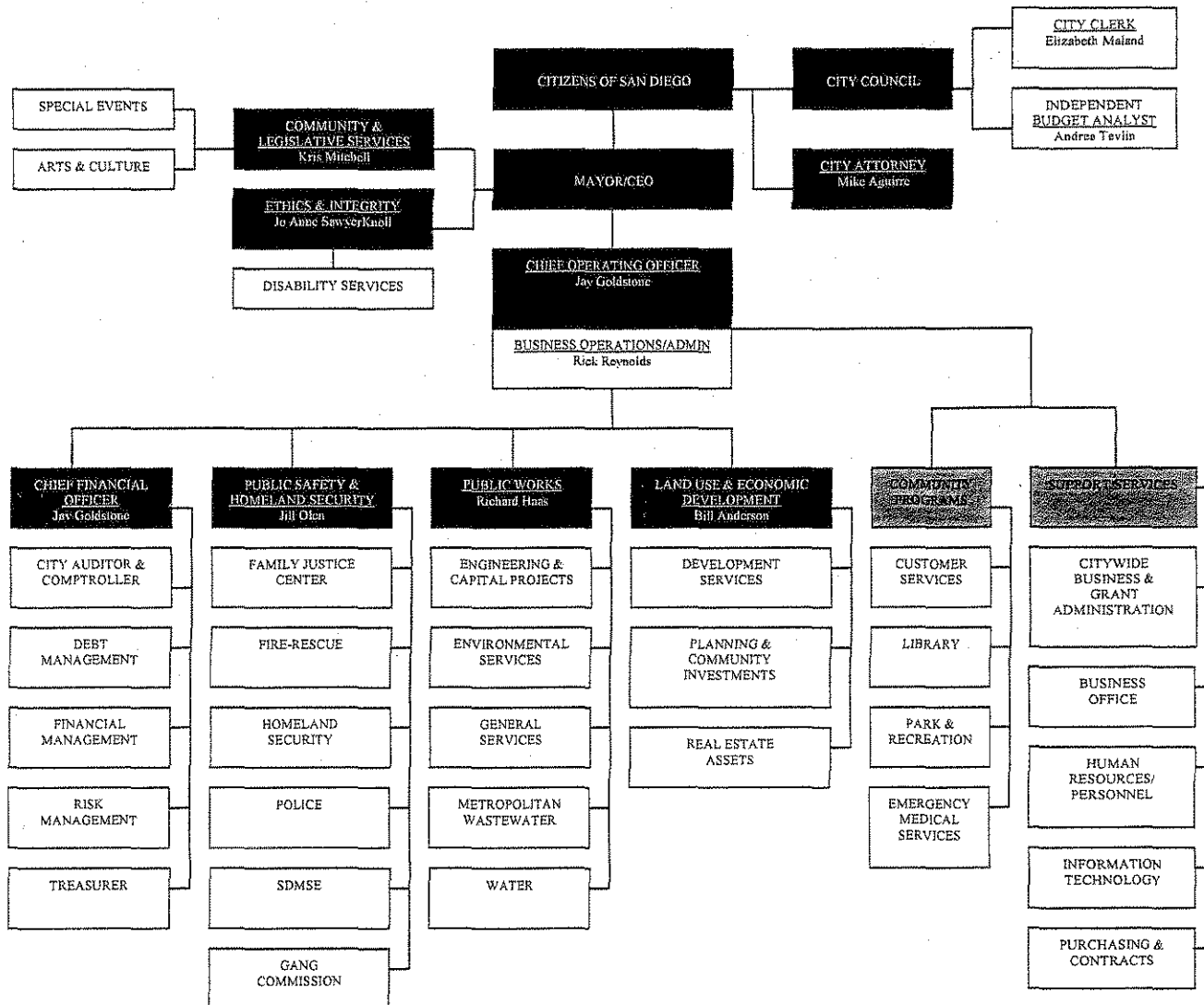


District 8
Councilmember Ben Hueso



City Attorney
Michael Aguirre

City of San Diego Organization Chart
(As of issuance of this report)



Financial Reporting Entity

In accordance with Governmental Accounting Standards Board Statement 14, the following component units are incorporated into the accompanying financial statements:

- Centre City Development Corporation (CCDC)
- City of San Diego Metropolitan Transit Development Board Authority (MTDB)
- Redevelopment Agency of the City of San Diego (RDA)
- San Diego Data Processing Corporation (SDDPC)
- San Diego Housing Commission (SDHC)
- San Diego Open Space Park Facilities District #1
- Community Facility and Other Special Assessment Districts
- Convention Center Expansion Financing Authority (CCEFA)
- San Diego City Employees' Retirement System (SDCERS)
- Public Facilities Financing Authority (PFFA)
- San Diego Convention Center Corporation (SDCCC)
- San Diego Facilities and Equipment Leasing Corporation (SDFELC)
- San Diego Industrial Development Authority (SDIDA)
- Southeastern Economic Development Corporation (SEDC)

Additionally, the City participates in a joint venture operation with a private company to provide for emergency medical and medical transportation services. This joint venture is a limited liability company named San Diego Medical Services Enterprise. The financial impact of the joint venture is displayed in the governmental funds balance sheet.

Budgetary Process

Pursuant to the City Charter, an annual budget is presented by the Mayor to the City Council for adoption. Set forth in this budget are the anticipated revenues and expenditures of the general fund, certain special revenue funds, enterprise funds, and certain debt service funds for the ensuing fiscal year. Additionally, project-length financial plans are presented to and adopted by council for the capital projects funds. The level of budgetary control (the level at which expenditures cannot legally exceed the appropriated amount) is maintained at the fund, department, and object class level. Object classes are defined as salaries and non-personnel expense (including employee benefits). Copies of the City's Budgets are available at the Financial Management Office located at 202 C Street, MS8A, San Diego, CA 92101.

The City also maintains an encumbrance accounting system as one technique of accomplishing budgetary control. Encumbered amounts are reported as reservations of fund balances since the commitments are expected to be honored in subsequent periods.

FACTORS AFFECTING FINANCIAL CONDITION

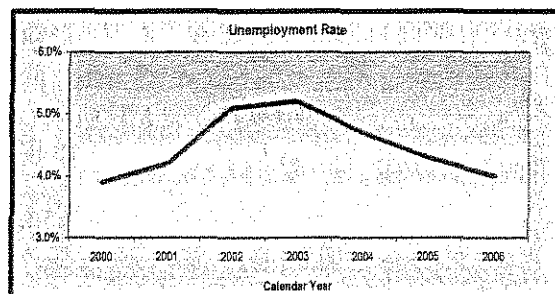
Economic Factors

Income

In January 2007, the San Diego Association of Governments (SANDAG) reported that between 2000 and 2006, the median household income in the San Diego region rose by 33.2%, from \$45,826 to \$61,043.

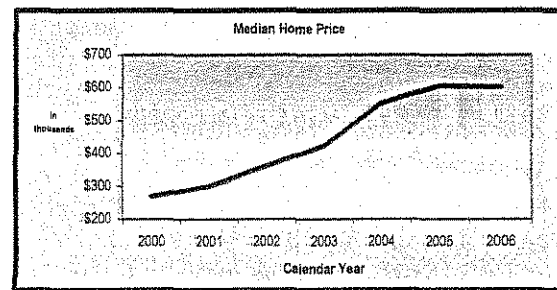
Unemployment

The unemployment rate is a critical indicator of the relative strength in the local economy. According to the Bureau of Labor Statistics, the City of San Diego's unemployment rate was 4.0% for the calendar year 2006. This reflects a 1.2% decrease from a 10 year high of 5.2% in the calendar year 2003, a .7% decrease from calendar year 2004, and a .3% decrease from calendar year 2005. The City of San Diego's unemployment rate is .6% below the national average and .9% below the average for the State of California for the calendar year 2006.



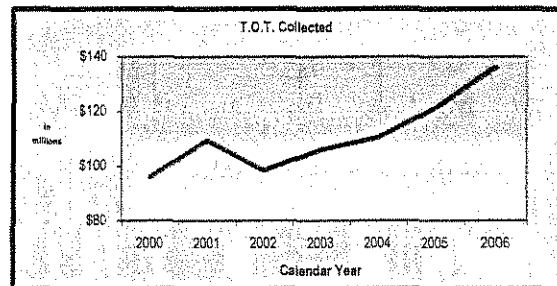
Housing and Construction

According to a report by the National Association of Realtors, the median residential home price in the San Diego area dropped 0.4% from calendar year 2005 to 2006. However, median residential home prices in the San Diego area increased 125% from calendar years 2000 to 2005. Home sales during this growth in median home prices have resulted in stronger than average property tax returns for the City and have fueled increased activity in the construction sector. However, there has recently been a significant slowing in the housing market and a softening in housing prices and therefore the recent growth in property tax revenues may not continue and may in fact decline.



Tourism

The City of San Diego has continued to experience a growth in tourism during calendar year 2006, resulting in a 12.3% increase in Transient Occupancy Tax (TOT) collections from calendar year 2005, and a 41.6% increase from calendar year 2000. According to the San Diego Convention & Visitors Bureau, average occupancy rates of hotels located in the San Diego area have also continued to improve during calendar years 2005 and 2006, increasing 1.7% and 1.5%, respectively. Additionally, a total of 32.2 million visitors spent approximately \$7.7 billion at local businesses in the San Diego area during calendar year 2006.



Water Supply

The City of San Diego is located in a semi-arid coastal climate environment and receives an average annual rainfall of approximately 10 inches. The 1.3 million people living in San Diego use an average of 210 million gallons per day of potable water. The City's population is projected to increase 50% in the next 25 years, and the City projects this growth will increase demand for potable water by approximately 25%. Up to 90% of the City's existing water supply is imported from the Colorado River and the California State Water Project ("SWP"). The San Diego County Water Authority ("CWA") purchases the majority of its water supplies from the Metropolitan Water District of Southern California ("MWD"). As of July 18, 2007, MWD indicated that it had sufficient water supplies in storage to sustain two years of a supply/demand scenario similar to 2007 with enhanced conservation efforts beginning immediately.

The majority of MWD's water supplies originate from the Sacramento River Delta before being pumped into the California Aqueduct for transportation to Southern California. On August 31, 2007, a federal court ordered state and federal water managers to reduce pumping out of the Delta during certain times of the year in order to protect the Delta Smelt, an endangered fish species. It is unknown how long these restrictions will be in place but they are expected to last at least one year. The California Department of Water Resources (DWR) estimates that the court order will reduce the amount of water available by 10% to 35%. Statewide, California has experienced one of the driest years on record for the 2007 water year (ended September 30). While the National Weather Service is predicting above average precipitation for Northern California, dry weather is expected to persist in Southern California, potentially reducing the amount of local water available to the CWA and the City.

The potential for drought and the reduced availability of imported water could have an adverse impact on the City's economic growth. The San Diego Municipal Code provides that the Mayor, upon the recommendation of the Director of the Water Department, is authorized to determine the appropriate water conservation stages, if any. It was the advice of the Director, which was accepted by the Mayor, to declare a stage 1 (voluntary compliance) water watch. Under state law, the City is required to verify that there will be a sufficient water supply over a 20 year window before approving certain large developments. In the event that the City is unable to make such determinations due to the reduction of water availability, the level of development in the City could be reduced.

Regulatory Actions

In November 2006, the United States Securities and Exchange Commission (SEC) entered an Order (the "Order") sanctioning the City of San Diego for committing securities fraud in connection with the 2002 and 2003 offer and sale of over \$260 million in municipal bonds and for preparing and filing information pursuant to continuing disclosure agreements under Exchange Act Rule 15c2-12 with respect to \$2.29 billion in outstanding City bonds and notes. The findings contained in the Order were made pursuant to the City's offer of settlement. The SEC, in the Order, concluded that the City, through its officials, acted with scienter.

In the Order, the SEC found that at the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut. The SEC found that the City's looming financial crisis resulted from (1) the City's intentional underfunding of its pension plan from fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003. The SEC found that despite the magnitude of the problems the City faced in funding its future pension and retiree health care obligations, the City conducted five separate municipal bond offerings, raising more than \$260 million, without disclosing these problems to the investing public. The SEC found that in each of these offerings, the City prepared disclosure documents that are used with municipal securities offerings—that is, preliminary official statements and official statements—and made presentations to rating agencies. In addition, in 2003 it prepared and filed information pursuant to continuing disclosure agreements under Exchange Act Rule 15c2-12 with respect to \$2.29 billion in outstanding City bonds and notes.

The SEC credited the City with having taken remedial action before the Order was issued and found that since 2005 the City has implemented several remedial measures with a view to detect and prevent securities violations. Specifically, the City has terminated certain officials in the City Manager's and Auditor and Comptroller's offices or has allowed them to resign. The City has hired a full time municipal securities attorney who is responsible for coordinating the City's public disclosure and who has conducted continuing education for the City's deputy attorneys on the City's disclosure requirements.

The SEC credited the City with hiring new outside professionals including new auditors for its fiscal year audits. The SEC also found that the City hired individuals not affiliated with the City to act as the City's audit committee to conduct an investigation of the City's prior disclosure deficiencies and make recommendations to prevent future disclosure failures. The SEC found that the City has also hired new disclosure counsel for all of its future offerings, who will have better and more continuous knowledge on the City's financial affairs. The SEC found that the disclosure counsel has conducted seminars for City employees on their responsibilities under the federal securities laws.

The SEC found that the City has also enacted ordinances designed to change the City's disclosure environment:

1. The City created a Disclosure Practices Working Group, comprised of senior City officials from across city government. The Working Group is charged with reviewing the form and content of all the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to securities issued by the City or its related entities; and conducting a full review of the City's disclosure practices and to recommend future controls and procedures.
2. The Mayor and City Attorney must now personally certify to the City Council the accuracy of the City's official statements.
3. The City Auditor must annually evaluate the City's internal financial controls and report the results to the City Council.

As part of the settlement with the SEC, the City agreed to cease and desist from future securities fraud violations. The City also agreed to retain an Independent Consultant acceptable to the SEC. The Independent Consultant is required to conduct annual reviews for a three-year period, following the November 2006 Order, of the City's policies, procedures, and internal controls regarding its disclosures for offerings, including disclosures made in its financial statements, pursuant to continuing disclosure agreements, and to rating agencies. The Independent Consultant is also required to review, for the three year period, the procedures and internal controls regarding the City's hiring of internal personnel and external experts for disclosure functions, and the implementation of active and ongoing training programs to educate appropriate City employees, including officials from the City Auditor and Comptroller's office, the City Attorney's office, the Mayor, and the City Council members regarding compliance with disclosure obligations.

The Independent Consultant is required to make recommendations concerning related policies, procedures, and internal controls with a view to assuring compliance with the City's disclosure obligations under the federal securities laws. The Independent Consultant is to assess, in years two and three, whether the City is complying with its policies, procedures, and internal controls,

whether the City has adopted any of the Independent Consultant's recommendations from prior year(s) concerning such policies, procedures, and internal controls for disclosures for offerings, and whether the new policies, procedures, and internal controls were effective in achieving their stated purposes.

On June 7, 2007, the Initial Report of Independent Consultant to the City of San Diego (the "Independent Consultant's Report") was released. The purpose of the Independent Consultant's Report was to describe the review and assessment of the City's policies, procedures, and internal controls regarding i) its financial and other disclosures, ii) the hiring of internal personnel and external experts for disclosure functions, and iii) the implementation of active and ongoing training programs to educate appropriate City employees regarding compliance with disclosure obligations, and to provide conclusions and recommendations with respect to these matters.

Additionally, the Independent Consultant's Report recognizes the complexity of the City's issues and includes numerous actions that are planned to be addressed in the future, including:

- Ongoing analysis and observation by the Independent Consultant of the City's disclosure process, including participation in future offering disclosure processes,
- Implementation of a new Enterprise Resource Planning (ERP) system,
- Ongoing training for the City Council, City Officials, and City employees, and
- Hiring a qualified internal auditor to provide reliability of the City's internal control structure.

The Independent Consultant observed that the City had made progress with its remediation efforts, but that there is much left to be done that will require an intensive and substantial effort.

On July 23, 2007, the SEC issued a letter to the City and to the Independent Consultant recognizing the recommendations outlined in the Independent Consultant's Report and indicating its understanding that subsequent reports from the Independent Consultant would provide more complete, specific, and concrete recommendations with specific deadlines. The SEC also requested a response from the City in regards to the recommendations outlined in the Independent Consultant's Report, including an estimated timeframe for implementation of the recommendations.

On September 25, 2007 the City responded to the SEC, this response was approved by the Council Resolution No. 303021. This response to the SEC is summarized as follows:

- The CFO, along with representatives of the Audit Committee and the Independent Budget Analyst, interviewed candidates for the Internal Auditor. The candidate selected began work on October 22, 2007. The Charter Review Committee is also looking into a Charter change which would separate the internal audit function from the comptroller and management duties. This revision will need to be approved by a vote of the public.
- The City has established an Audit Committee comprised of 3 Council members and an ad hoc committee of 3 outside advisors who bring extensive technical expertise to the Committee. The ad hoc committee began serving September 10, 2007. The Charter Review Committee is also looking into a Charter change which would formally establish the composition of the Audit Committee. This revision will need to be approved by a vote of the public.
- The City has selected a software vendor for an enterprise resource system. The current schedule calls for the implementation of a new core system by October 2008, followed by the implementation of the human resource/payroll system by January 2009.
- The CFO position was established in calendar year 2006 and all financial related activities and responsibilities of the City fall under this position.
- The City is carefully evaluating the Independent Consultant's recommendation to consider moving toward a shelf-like disclosure system. The City has made many improvements to internal controls regarding the release of financial information to the public capital markets (e.g. creation of the DPWG, CFO, and Audit Committee). Accordingly, any shelf-like registration would take into consideration procedures currently in place which were designed to ensure that the City would not make misleading statements or omissions to the market place in the future.

Financial Information

Pension Benefits

In fiscal year 1927, the City established the San Diego City Employees' Retirement System ("SDCERS"), a public employee retirement system. The pension plan ("Plan") is a defined benefit plan and is administered by the SDCERS' Board to provide retirement, disability, death, and survivor benefits for its members. The SDCERS Board contracts with an actuary to perform an

annual actuarial valuation based on the assumptions adopted by the SDCERS Board. A new actuarial firm, Cheiron Inc., was hired by the SDCERS board to perform the 2005 and 2006 actuarial reports.

The actuarial valuations performed by Cheiron for the fiscal years ended June 30, 2006 and June 30, 2005 reported as follows:

San Diego City Employees' Retirement System (City of San Diego)

	Fiscal Year Ended		
	June 30, 2006	June 30, 2005	% Change
<u>Membership</u>			
Total Members (active, disabled, beneficiaries and retired)	17,647	17,429	1.3%
<u>Assets and Liabilities</u>			
Total Actuarial Liability	\$ 4,982,699,455	\$ 4,377,092,948	13.8%
Market Value of Assets	3,981,931,694	3,205,721,975	24.2%
Actuarial Value of Assets	3,981,931,694	2,983,079,852	33.5%
Unfunded Actuarial Liability	\$ 1,000,767,761	\$ 1,394,013,096	(28.2%)
Funding Ratio	79.9%	68.2%	11.7%

It is common practice to base consecutive actuarial valuations on consistent pre-defined parameters; however, occasional methodology changes are required to reflect prevailing practices within the industry. The actuarial methodology changes with the most significant impact to the unfunded actuarial liability between fiscal years 2005 and 2006 are related to the inclusion of certain "contingent" liabilities in the valuation and a change in the asset smoothing method, both of which are discussed in detail below.

The actuarial valuation information presented above for the fiscal year ended June 30, 2005 is based upon historical assumptions in regards to some benefits being viewed as contingent in nature, and therefore, does not include information on liabilities pertaining to the Corbett Settlement or the 13th Check, both of which were included as liabilities in the fiscal year 2006 valuation. Additionally, SDCERS has established reserves of assets in an amount approximately equivalent to the related liability for the following items: Supplemental Cost of Living Adjustment, Employee Contribution Rate Increase Liability, and the Deferred Retirement Option Plan Liability. The assets placed in these reserves, as well as the corresponding liability, have also been excluded from the fiscal year 2005 actuarial valuation.

For the benefit of the reader, the following table presents the balances of all liabilities excluded from the actuarial valuation for the fiscal year ended June 30, 2005:

SDCERS Other Liabilities

Corbett Settlement	\$ 58,923,978
13th Check	56,686,313
Supplemental Cost of Living Adjustment *	17,839,967
Employee Contribution Rate Increase Liability *	8,905,418
Deferred Retirement Option Plan Liability *	227,223,791
Total Other Liabilities	<u>\$ 369,579,467</u>

* SDCERS has established reserves of assets approximately equivalent to related liability.

A detailed explanation of the liabilities and their related assets can be found in the actuarial valuations for fiscal year 2005 and fiscal year 2006 which can be obtained at the SDCERS main office located at 401 West A Street, Suite 400, San Diego, CA 92101.

For the purposes of calculating the City's net pension obligation (NPO), calculated amounts include the effects from the Corbett settlement liability and the employee contribution rate increase liability due to the City's position that these liabilities are non-contingent in nature. As such, the following schedule shows the City's view of its revised unfunded actuarial liability as of June 30, 2005 and presents a comparison to the fiscal year 2006 valuation. The employee contribution rate increase liability and its corresponding asset reserve are not included in the revised calculation as of June 30, 2005 due to its immaterial effect on the unfunded actuarial liability. Additionally, the City views the liabilities related to the 13th check as contingent in nature, and therefore, excluded them from the revised calculation of the City's unfunded actuarial liability.

Calculation of City's Unfunded Actuarial Liability

	Fiscal Year Ended		% Change
	June 30, 2006	(revised)*** 6/30/2005	
Actuarial Liability (Cheiron*)	\$ 4,982,699,455	\$ 4,377,092,948	
Corbett Settlement (Cheiron*)	n/a **	58,923,978	
Total Actuarial Liability	4,982,699,455	4,436,016,926	12.3%
Actuarial Value of Assets (Cheiron*)	3,981,931,694	2,983,079,852	33.5%
Unfunded Actuarial Liability****	\$ 1,000,767,761	\$ 1,452,937,074	(31.1%)
Funding Ratio	79.9%	67.2%	12.7%

* SDCERS Actuary

** Liabilities related to the Corbett Settlement and the 13th Check are included in actuarial liabilities in fiscal year 2006.

*** As discussed in the narrative, the City believes the liability related to the Corbett Settlement should be included in total actuarial liabilities.

**** Unfunded Actuarial Liability has been calculated in accordance with the projected unit credit (PUC) method, see table on page 21 for comparison to entry age normal (EAN) method.

As a result of the approval of revised assumptions and methodologies on October 20, 2006 by the SDCERS Board of Administration, the actuarial valuation for the fiscal year ended June 30, 2006 includes the liabilities resulting from the Corbett Settlement and the 13th Check as well as both the asset reserves and the corresponding liabilities related to the Deferred Retirement Option Plan and the Supplemental Cost of Living Adjustment. The recognition of these previously excluded liabilities increased actuarial liabilities in the valuation dated June 30, 2006 by approximately \$113 million over amounts reported in fiscal year 2005.

As previously stated, the City views the exclusion of the Corbett Liability from the Actuarial Liability as inappropriate and therefore has already restated its Net Pension Obligation and amended its required supplementary schedules accordingly. The City views the SDCERS Board of Administration's decision regarding the 13th Check liability as a change in accounting estimate and therefore will account for it prospectively beginning with its fiscal year 2007 financial statements. This treatment reflects City management's policy of valuing and reporting pension liabilities using the actuarial valuation from the fiscal year ending one year prior to the date of its financial statements. Additionally, total actuarial assets, total actuarial liabilities, and the funding ratio increased in fiscal year 2006 partially due to the inclusion of the asset reserves and liabilities related to the Deferred Retirement Option Plan and the Supplemental Cost of Living Adjustment.

In addition to the inclusion of the aforementioned assets and liabilities in the June 30, 2006 valuation, the SDCERS Board of Administration voted to move from a "book value based" asset smoothing method to the "expected asset value" smoothing method. The expected asset value smoothing method is based on asset market value and is a more commonly used practice in actuarial valuations because it is a more effective technique to dampen the volatility in asset values that can occur due to fluctuations in market conditions. A part of this change was to set the actuarial value of assets equal to the market value of assets as of June 30, 2006. This action increased the actuarial value of assets from the amounts reported in the fiscal year 2005 valuation by approximately \$184 million. SDCERS also changed the manner in which assets are apportioned between plan sponsors, which also resulted in increasing the actuarial value of assets in the City's plan. The following schedule shows the

effect of the specific components of the total change of the Unfunded Actuarial Liability between fiscal years 2005 and 2006:

SDCERS - City of San Diego
Source of Changes in Unfunded Actuarial Liability
(In Millions)

<u>Experience</u>	
1. UAL change due to investment experience	\$ (158.9)
2. UAL change due to purchased service credit	1.2
3. UAL change due to overall liability gain	(47.5)
<u>Contributions</u>	
4. UAL change due to contributions in excess of expected	(105.6)
<u>Actuarial</u>	
5. UAL change due to marking the smoothing method to market value	(183.8)
6. UAL change due to reflection of "contingent" liabilities	112.7
7. UAL change due to DROP and supplemental COLA	-
8. UAL change due to removal of liabilities in excess of IRC § 415 limits	(22.8)
9. UAL change due to removal of future disability benefits	(9.9)
<u>Total</u>	
10. Total net overall experience: sum 1 through 9	(414.6)
11. Expected change in UAL	21.4
12. Total change in UAL: 10 + 11	<u>\$ (393.2)</u>

The benefits awarded to some plan participants exceed the amount permitted for Internal Revenue Code (IRC) 401(a) pension plans such as SDCERS. In March 2001, the San Diego City Council established a Preservation of Benefit Plan to pay for benefits in excess of those allowed under the 401(a) plan. The Preservation of Benefit Plan is a qualified governmental excess benefit arrangement (QEBA) under IRC § 415(m), which is a vehicle created by Congress to allow the payment of promised pension benefits that exceed the IRC § 415(b) limits (and therefore cannot be paid from a qualified retirement plan). The Preservation of Benefit Plan is administered by the SDCERS Board separately from the City's 401(a) pension plan. On February 16, 2007, the SDCERS Board adopted the Preservation of Benefit Plan and Trust to carry out the intent of SDMC § 24.1601 et seq.

As background, IRC § 415(b) imposes dollar limits on the benefits payable from a qualified pension plan that receive favorable tax treatment. The dollar limit is \$175,000 for calendar year 2006; however, this limit is adjusted based upon the payee's age at retirement, and the benefit tested is adjusted by a number of factors.

The Preservation of Benefit Plan is unfunded within the meaning of the federal tax laws. Under the Internal Revenue Code the City may not pre-fund the Preservation of Benefit Plan to cover future liabilities beyond the current year, as with the 401(a) plan. Each year, SDCERS will determine the amount necessary to fund any pension benefits payable during the calendar year in excess of IRC § 415(b). This amount will include the projected amount of all excess pension benefits payable for the calendar year to existing and projected payees, as well as the projected cost of administering the Preservation of Benefit Plan. SDCERS will provide this information to the City and the City will fund this amount on an annual basis.

Any amounts remaining in the Preservation of Benefit Plan at the end of a calendar year will be carried forward to pay benefits and administration costs in the following year. As a result, the liability related to excess benefits for eligible active members of the system, amounting to approximately \$22.8 million, has been excluded from the actuarial valuation of the 401(a) retirement plan beginning in fiscal year 2006 (as shown in the table above). The estimated liabilities for retired members of the Preservation of Benefit Plan have not yet been provided to the City by SDCERS as a separate amount distinct from the City's core 401(a) pension plan. Accordingly, they are reflected in the actuarial liabilities of the 401(a) plan in the actuarial valuation dated June 30, 2006.

In fiscal year 2005, activities related to the Preservation of Benefit Plan for both retired and active members are included in the actuarial liabilities presented in the Required Supplementary Information (RSI) for the City's core pension plan and are valued using the same set of assumptions. In a review of the financial statements of other local governments, the City has noted significant diversity of practice in how governments are accounting for QBAs. As such, the City is in the process of

implementing a plan to account for the QEBA with SDCERS.

Certain other methodology changes were implemented for the June 30, 2006 valuation, which are discussed in detail in the valuation report. Additional information on the City's net pension obligation, annually required contribution, and the Corbett liability is discussed in Note 12 of the notes to the financial statements contained in the financial section of the CAFR and in the Required Supplementary Information section of the report.

On November 2, 2004, the public approved an amendment to Article 9, Sections 143 and 144 of the City's Charter regarding the retirement systems actuarial assumptions and the governance structure of SDCERS. Notable changes include:

- Effective fiscal year 2009, Unfunded Actuarially Accrued Liability shall be amortized using a 15 year assumption; for the 2006 actuarial valuation, Unfunded Actuarial Accrued Liabilities were amortized over 27 years reflecting the resetting of the amortization period pursuant to the settlement of the Gleason v. City of San Diego lawsuit. (The effects of this lawsuit on the pension system are disclosed in Note 12).
- Effective fiscal year 2009, new retirement benefits shall be amortized using a schedule no longer than 5 years.
- Effective April 2005 the composition of the SDCERS Board was changed to the following:
 - 7 members appointed by the Mayor, who are not associated with the City or Retirement system as employees, union members or beneficiaries,
 - 1 member who is an active employee in the police safety group, elected by the members of that group,
 - 1 member who is an active employee in the fire safety group, elected by the members of that group,
 - 2 members who are active employees in the general member group, elected by members of that group,
 - 1 member who is a retired member of the system and is elected by the retired members of the system, and
 - 1 member who is a City management employee and serves at the pleasure of the Mayor. This member must be the Chief Operating Officer, City Treasurer, Deputy or Assistant Chief Operating Officer or a similar position that reports to the Chief Operating Officer or Mayor. As of the issuance of this report, the Deputy Chief of the Office of Ethics and Integrity is assuming the responsibility of this position.

A review of the aforementioned charter revisions concerning SDCERS is currently underway. This includes examining the legality of changes to the City's amortization assumption made by way of revisions to the City Charter. California State Attorney General Opinion 04-710 concludes that a city charter cannot mandate a specified amortization schedule for retirement benefits or accumulated actuarial gains and losses. Furthermore, a recent legal ruling by the California Superior Court concluded that SDCERS Board has "plenary authority" over the retirement system in its administrative capacity. In March 2007, the SDCERS Board adopted a 20 year amortization assumption. The SDCERS Board has not indicated whether it will change to a 15 year amortization assumption for the purpose of determining the City's fiscal year 2009 Annually Required Contribution. The San Diego City Attorney's Office has opined that the voter's amendment to the Charter to establish a 15-year amortization requirement for accumulated actuarial losses simply establishes an upper boundary for the amortization of pension debt, and does not usurp or unduly interfere with the SDCERS Board's plenary authority and fiduciary responsibility in violation of the California constitution, and as a result, the 15 year amortization period is binding. Given the size of the City's current Unfunded Actuarially Accrued Liability, a change to a 15-year amortization schedule will have a significant impact on future annually required contributions. In relation to the implementation of a 15-year amortization, SDCERS issued a report titled "Summary and Answers to Frequently-Asked Questions about the June 30, 2006 Actuarial Valuation for the City of San Diego." This document stated that if a 15-year amortization of the unfunded actuarial liability was implemented, the City's Annual Required Contribution for fiscal year 2008 would increase by \$29.1 million over the requested contribution of \$137.7 million. Thus, a 15-year amortization period would result in an Annual Required Contribution of \$166.8 million. Comparatively, the City's fiscal year 2008 budget includes appropriations for a contribution of \$165 million to SDCERS.

The City notes that Governmental Accounting Standards expressly state that "a plan and its employers should apply the same actuarial methods and assumptions in determining similar or related information included in their respective financial reports." However, the GASB does not assign responsibility for determining actuarial assumptions to either the plan administrator or the plan sponsor. As such, the City and SDCERS will need to reach a consensus regarding the actuarial assumptions to be used for the fiscal year 2007 actuarial valuation in advance of its performance.

Following the most widely used actuarial cost method approved in Statement No. 25 of the Governmental Accounting Standards Board, as well as a recommendation from Cheiron, SDCERS Board of Administration voted to use the entry age normal (EAN) actuarial cost method to calculate future actuarial liabilities beginning with the fiscal year 2007 valuation. Historically, the actuarial valuations performed for SDCERS have calculated actuarial liabilities in accordance with the projected unit credit (PUC) method. This change of methodology will negatively impact the unfunded actuarial liability reported in the actuarial valuation for

the fiscal year ended June 30, 2007. A comparison of the two valuation methods for the fiscal year ended June 30, 2006 was included in the June 30, 2006 actuarial valuation and is provided on the following page for informational purposes only.

Unfunded Actuarial Liability Projected Unit Credit (PUC) vs. Entry Age Normal (EAN) For the Fiscal Year Ended June 30, 2006			
	PUC	EAN	% Change
Actuarial Value of Liability (Cheiron*)	\$ 4,982,699,455	\$ 5,191,961,336	4.2%
Actuarial Value of Assets (Cheiron*)	3,981,931,694	3,981,931,694	0.0%
Unfunded Actuarial Liability	1,000,767,761	1,210,029,642	20.9%
Funding Ratio	79.9%	76.7%	(3.2%)

*SDCERS Actuary

On November 7, 2006, the public approved an amendment to Article 9, § 143 of the City's Charter, requiring voter approval of certain increases in retirement system benefits for public employees. Specifically, this amendment requires voter approval of any ordinance that amends the City's retirement system by increasing the benefits of any employee. However, increases in retirement benefits due to cost of living adjustments do not require voter approval.

On August 3, 2007, the General Counsel of SDCERS issued a letter to the City stating their opinion in regards to the effective date of the fiscal year 2005 agreements between the City and the labor unions. As part of the agreements, several benefits were altered or eliminated for employees hired on or after July 1, 2005, including the Deferred Retirement Option Plan (DROP), the 13th Check, and the option to purchase years of service credits ("air-time"). According to their fiduciary counsel, "SDCERS is obligated to administer benefits in accordance with its plan documents." However, the City did not enact such ordinances until January 17, 2007, which took effect on February 16, 2007. Therefore, the General Counsel of SDCERS and their outside counsel opine that the effective date of the agreements with the labor unions is February 16, 2007, the date that the benefit changes were codified into the plan document. On October 9, 2007, the City filed a petition for declaratory relief to determine the effective date of retirement benefit changes for employees hired between July 1, 2005 and February 16, 2007.

On September 21, 2007 the President of the SDCERS Board of Administration issued a press release stating that, under the direction of the Board of Administration, SDCERS' staff, actuary, and legal counsel, he had reviewed the SDCERS purchase of service credit program, and that his review concluded the following:

- With respect to SDCERS' service credit pricing structure that was in place prior to November 2003, Cheiron, SDCERS actuary, has determined that the full cost was not reflected in the price then charged to SDCERS members.
- This pricing shortfall, which totals approximately \$146 million, has been included in the System's Unfunded Actuarial Liability since the inception of the service credit program.
- With respect to the SDCERS' service credit pricing in place since November 2003, Cheiron advised SDCERS that structure covers the full projected cost to the System when members purchased the service credits.

The pricing shortfall of approximately \$146 million, which is included in the System's Unfunded Actuarial Liability, is reported in the RSI of these financial statements.

Additional information regarding the City's pension trust fund, including the City's NPO, can be found in Note 12 of the notes to the financial statements.

Other Post Employment Benefits

Retiree Health

The City provides certain healthcare insurance benefits to a variety of retired employees, as provided for in SDMC Sections 24.1201 through 24.1204 (the "Plan"). Currently, the benefits are primarily for employees who were actively employed on or after October 5, 1980 and were otherwise entitled to retirement allowances. Employees who retired or terminated prior to October 6,

1980, who were eligible for retirement allowances prior to that date, are also eligible for healthcare benefits, limited to a total of \$1,200 per year. Additionally, employees who were hired on or after July 1, 2005 and become eligible for retirement allowances in the future are also eligible for healthcare benefits, limited to a total of \$1,200 per year.

In accordance with SDMC Sections 24.12 and 24.15, amounts have been transferred from the calculated surplus annual realized earnings of SDCERS pension assets to the system's employer contribution reserve for the purposes of offsetting the City's funding of retiree health benefits. An equivalent amount has been paid by the City into a SDCERS account for post employment healthcare benefits. It is from this reserve that SDCERS transferred funds into the Retiree Health Trust fund and then approved the post employment healthcare benefits. As a result of the retiree health care benefit expense being funded by an SDCERS employer contribution reserve, the City offset the annual required contributions submitted to SDCERS by the same amount. This offset to annual required contributions resulted in an increase to the net pension obligation which is amortized and included in future contribution calculations. In fiscal year 2005, \$7.9 million of the reserve balance was used to pay for post employment healthcare benefits and the remaining \$1.2 million was transferred to the Defined Benefit Pension Plan. Effective February 2005, the City began paying for post employment healthcare benefits on a pay-as-you-go basis for approximately 4,100 retirees who received either City paid insurance or were reimbursed for other health insurance costs incurred. According to City Attorney Opinion No. 2007-04, the trust arrangement between the City and SDCERS was not affected by the change in the funding mechanism, and therefore, the City has reported all activity related to retiree healthcare as a pension trust in the fiduciary section of the CAFR. (See additional information in Note 13). In fiscal years 2006 and 2007, the annualized cost of retiree health benefits was approximately \$23.8 million and \$26.8 million, respectively. The City's obligation of this cost was \$17.6 million and \$20.9 million, respectively.

The following schedule details employer payments for retirement health benefits:

<u>Retiree Health Care Costs</u> (In thousands)					
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Amount Paid Directly from City	\$ -	\$ -	\$ 6,949	\$ 17,554	\$ 20,915
Amount Paid from 401(h) reserve	11,450	12,829	7,910	-	-
Amount Paid by Retirees	2,981	5,458	5,978	6,226	5,915
Total Retiree Health Expenditures	<u>\$ 14,431</u>	<u>\$ 18,287</u>	<u>\$ 20,837</u>	<u>\$ 23,780</u>	<u>\$ 26,830</u>

In July 2004, GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions" ("GASB 45"), which addresses how local governments should account for and report their costs and obligations related to other post employment benefits (OPEB). This statement is effective for the City for periods beginning after December 15, 2006 (i.e. beginning in fiscal year 2008). GASB 45 establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial statements. The City will implement GASB 45 in its financial statements for the fiscal year ended June 30, 2008. Nevertheless, an actuarial valuation, dated June 1, 2007, of the City's postretirement welfare benefit plans was performed for the purpose of determining its annual cost in accordance with GASB 45.

During fiscal year 2007, the City continued a "pay as you go" approach to funding retiree health costs. Specifically, for valuation purposes, the City used a 5% earnings assumption, an inflation factor of 3%, and a 30 year amortization period. The following table presents the actuarial accrued liability for all retirees, deferred retirement participants, vested terminated and active members, and the annual required contribution for fiscal year 2008 had the City already implemented GASB 45.

<u>Retiree Healthcare Liabilities</u>	
Actuarial Accrued Liability	\$ 1,097,196,731
Annual Required Contribution	106,930,215

Defined Contribution Plan

The City has established the Supplemental Pension Savings Plan ("SPSP"), a defined contribution plan administered by Wachovia Corporation, which provides pension benefits for eligible employees. In a defined contribution plan, benefits depend solely on amounts contributed to the plan plus investment earnings. Eligible employees may participate from the date of employment and vest at a rate of 20% for each year of service. The City also established a 401(k) Plan effective July 1, 1985. The plan is a defined contribution plan also administered by Wachovia Corporation, to provide pension benefits for all eligible employees. Employees participating in the 401(k) plan are immediately 100% vested.

Deferred Compensation Plan

In addition to the defined benefit and contribution plans, the City also offers its employees a deferred compensation plan created in accordance with Internal Revenue Code § 457. The plan, available to all eligible City employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, disability, or an unforeseeable emergency.

Additional information on the City of San Diego's pension activity may be found in Notes 12 and 13 of the notes to the financial statements.

Long-Term Financial Outlook

In fiscal year 2007, the City compiled a Five-Year Financial Outlook covering fiscal years 2008 through 2012. This document is an examination of the City's long range fiscal condition and financial challenges. During fiscal year 2007, the City experienced greater than anticipated revenue growth and less than anticipated expenditures. Additionally, the Fiscal Year 2008 Budget includes a pay raise for Police Officers Association members which were not included in the Five-Year Outlook. As a result, the City intends to update the Five-Year Outlook periodically to account for changed circumstances. In addition to other issues, the Financial Outlook concentrates on eight significant areas that must be addressed in order to restore and preserve the fiscal integrity and/or meet the legal obligations of the City. These eight significant areas are identified below:

1. Funding the City's Pension Plan.
2. Funding the City's General Fund reserves.
3. Funding deferred maintenance and capital improvement needs.
4. Funding the City's Post Employment Medical Program.
5. Funding the City's new obligations under Storm Water Runoff Permits.
6. Funding the City's Americans with Disabilities Act (ADA) obligations.
7. Funding the City's Workers' Compensation Fund.
8. Funding the City's Public Liability Fund.

The Financial Outlook relies on several assumptions, including revenue and expenditure growth estimates, to identify priorities to address in City Budgets over a five year period. The Financial Outlook assumes a significant financial commitment toward funding the aforementioned eight areas, and as part of that commitment, the outlook projected an \$87 million operating deficit for the fiscal year ended June 30, 2008. In subsequent periods, the Financial Outlook projects recurring operating deficits ranging from \$173 million to \$179 million, assuming that additional savings opportunities or revenue sources are not identified.

In order to address the projected operating deficits, the outlook discusses several potential corrective actions; however, these corrective actions are contingent on future events and City Council actions and as such, the Financial Outlook does not reflect a binding commitment of the City. The extent to which these corrective actions will mitigate future operating deficits as identified in the Financial Outlook is unknown at the time of issuance of this report. However, the City Council recently approved the Fiscal Year 2008 Appropriation Ordinance implementing the fiscal year 2008 budget which included several initiatives proposed by the Mayor in the Financial Outlook. Specifically, the appropriations ordinance reflected a balanced budget and the City's commitment to funding pension and other post employment healthcare liabilities.

The 2008 budget contained appropriations to fund current year expenses and an additional \$25 million set aside for the City's Other Post Employment Medical expenses. To date, the City has set aside \$5 million in addition to the \$25 million estimated to fund retiree healthcare, which is paid for on a pay-as-you-go basis. These funds have been transferred to a special revenue fund, which is separate from the existing Retiree Health Insurance Trust Fund used to pay retiree healthcare benefits, and the funds are maintained as part of the City Treasurer's investment portfolio. These assets are not in a trust vehicle established to protect and accumulate assets and accordingly can not yet be credited toward the City's annually required contribution for Retiree Healthcare liabilities in accordance with Governmental Accounting Board Standard 45.

The 2008 Budget also included appropriations for the City's full Annually Required Contribution of \$137.7 million to the City's Pension plan plus \$27.3 million in additional contributions. Amounts contributed in addition to the Annually Required Contribution will be credited to the City's NPO and UAAL.

In addition to the funding of pension and other post employment healthcare expenses, the City's 2008 budget included:

- An additional \$18 million for compliance with Storm Water Permits.
- An additional \$15.7 million for deferred maintenance.
- An additional \$10 million for Americans with Disabilities Act Compliance.
- An additional \$5 million in funding for Public Liability Reserves.
- A budgeted reserve contribution of \$3.5 million.

Funding requirements for Workers' Compensation are planned to be addressed in Fiscal Year 2009, as discussed in the five year Financial Outlook, and were not addressed in the Fiscal Year 2008 budget. In addition to the allocation of funds in the Fiscal Year 2008 Budget, the City Charter was recently amended to enable the City to contract for certain services, allowing a "Managed Competition" plan to be undertaken by the City. Managed Competition involves undertaking a review and redesign of how City services are delivered, with a goal of increasing the efficiency of City operations. Once completed and operating segments have achieved the efficiency gains identified in the first step of the Managed Competition plan, operating segments are competed against private sector suppliers in an effort to determine the lowest cost approach to service delivery. If private sector suppliers are the lowest bidder, the services will be outsourced. The potential savings from Managed Competition and the effect on the projected deficits cannot be determined at this time.

Another key component of the corrective actions identified in the Financial Outlook is position eliminations. Position elimination goals are achieved through a combination of eliminating budgeted positions that were historically held vacant and through streamlining efforts known as Business Process Reengineering (BPR). The Financial Outlook projects the elimination of over nine hundred budgeted positions over the three year period from 2008 through 2010. In an effort to achieve the goals outlined in the Financial Outlook, the Fiscal Year 2008 budget process identified and eliminated over six hundred fifty budgeted positions citywide. As part of this citywide reduction, four hundred sixty five general fund positions were eliminated. As a result of position eliminations and restraint in hiring through Fiscal Year 2007, the City realized significant budgetary savings for personnel expenditures of approximately \$34.6 million for the year ended June 30, 2007.

The City's Five-Year Financial Outlook can be obtained at the Financial Management Office, 202 C Street, MS8A, San Diego, CA 92101.

OTHER FINANCIAL INFORMATION

Independent Audits

The City Charter requires an annual audit by independent certified public accountants. The goal of an independent audit is to provide reasonable assurance that the financial statements are free of material misstatements. An independent audit involves examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by the City; and evaluating the overall financial statement presentation. In addition, the City is required to undergo an annual Single Audit in conformity with the U.S. Office of Management and Budget Circular A-133, "Audits of State and Local Governments and Non-Profit Organizations." As part of the City's Single Audit, tests are performed on internal control activities, including that portion related to federal award programs, to determine the City's compliance with applicable laws, regulations, contracts and grants.

As reported in the Auditor and Comptroller's Annual Reports on Internal Controls and the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards for the fiscal year June 30, 2003, which were both presented to the City Council, the City's internal control framework contains material weaknesses and requires significant improvements in order to produce timely and accurate financial statements in a cost effective manner. The internal control weaknesses identified in those reports were a primary contributor to the need for restated fiscal year 2002 ending balances (as reported in the City's FY 2003 CAFR). These conclusions are supported by the findings and recommendations on the City's internal control framework and compliance with applicable laws and regulations provided by the City's independent auditors. The Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards for the fiscal year ended June 30, 2003 has been included as part of the City's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2003. The Independent

Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards for the fiscal year ended June 30, 2004 also reported material weaknesses to the internal control framework; however, this report is not included in the fiscal year 2004 CAFR. Additionally, the Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program, Internal Control Over Compliance and the Schedules of Expenditures of Federal Awards and Governor's Office of Emergency Services Grants in Accordance With OMB Circular A-133 for the fiscal years 2003 and 2004 reported compliance, in all material respects, with the requirements that are applicable to each of its major federal programs with the exception of five specific instances. City management is currently in the process of improving the internal controls over compliance in response to these issues. Both the CAFR and the Auditor and Comptroller's Annual Reports on Internal Controls for each calendar year can be obtained at the City of San Diego Auditor & Comptroller's Office, 202 C Street, MS6A, San Diego, CA 92101.

Cash Management

The City Treasurer is responsible for investment of the City's cash. Eligible investments include, but are not limited to, obligations of the U.S. Treasury and U.S. Agencies, demand deposits, negotiable certificates of deposit, bankers' acceptances, medium-term corporate notes, repurchase agreements, and commercial paper in compliance with Sections 53601-53635 of the State Government Code. The City's cash is invested under a pooled money concept, with maturities planned to coincide with projected needs, with the primary objective of preserving principal. During fiscal year 2005, the average daily pooled portfolio balance was approximately \$1.24 billion, with a weighted average maturity of 487 days. Most of these monies are held in funds that have restricted uses. The largest balances, for instance, are found in the utility funds. The average earned income yield on pooled investments was 2.07%, as compared to 1.75% in the prior year.

The City Treasurer's investment policy has an objective to minimize credit and market risks while maintaining a competitive yield on its portfolio. All non-negotiable time certificates of deposit and demand accounts in excess of the amounts insured by the Federal Deposit Insurance Corporation are required to be fully collateralized with mortgages or eligible securities in accordance with California State law. The City's investments are held by the City's custodian bank in the City's name, or the nominee name of the custodian bank, as collateral for a reverse repurchase agreement with the counterparty's custodian bank or with a third party trustee, e.g., California State Treasurer's Office.

Additional information on the City of San Diego's cash management activity may be found in Note 3 of the notes to the financial statements.

Risk Management

The City is exposed to various risks of loss related to torts: theft of, damage to, and destruction of assets; injuries to employees; and natural disasters. The City has established various self-insurance programs and maintained contracts with various insurance companies to manage excessive risk. Additional information on the City of San Diego's risk activity may be found in Notes 15 and 16 of the notes to the basic financial statements.

Sincerely,

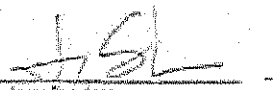
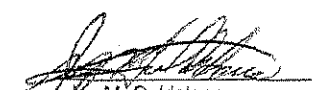
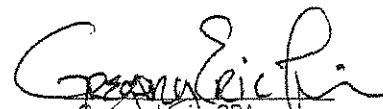

Jerry Sanders
Mayor
Jay M. Goldstone
Chief Operating Officer
Gregory Levin, CPA
Comptroller

Exhibit 7

Article 4: City Employees' Retirement System

Division 16: Preservation of Benefit Plan

*("Preservation of Benefit Plan"
added 3-19-2001 by O-18930 N.S.)*

§24.1601 Creation

- (a) A "Preservation of Benefit Plan" ("Plan"), separate and apart from any other plan administered by the Retirement Board, is established and adopted to preserve the benefits otherwise earned by Members of the Retirement System to the extent their benefits are reduced by the limitations on benefits imposed by Section 415 of the Internal Revenue Code ("Code").
- (b) This Plan is intended to be a "qualified governmental excess benefit arrangement" within the meaning of Section 415(m) of the Code. It shall be deemed a portion of the Retirement System solely to the extent required under, and within the meaning of, Section 415(m)(3) of the Code and Article IX of the San Diego City Charter.
- (c) In accordance with section 415(m) of the Code, this Plan is established solely for the purpose of providing to participants and their beneficiaries that part of their annual benefit otherwise payable under the Retirement System that exceeds the limitations on benefits imposed by section 415 of the Code.
- (d) This Plan is an "exempt governmental deferred compensation plan" described in section 3121(v)(3) of the Code. Sections 83, 402(b), 457(a) and 457(f)(1) of the Code shall not apply to this Plan. With respect to Code section 457(a), the maximum amount that may be deferred under this Plan on behalf of any Participant for the taxable year may exceed both the amount in Code section 457(b)(2) (as adjusted for cost of living increases) and the percent of the participant's includable compensation in that Code section. The System will not hold any assets or income under this Plan in trust for the exclusive benefit of participants or their beneficiaries.

(Added 3-19-2001 by O-18930 N.S.)

§24.1602 Eligibility

- (a) Participation in this Plan is limited to those Members of the Retirement System whose benefits at the time of payment are reduced by Section 415 of the Code.

Exhibit 8

- (i) the amount determined under section 412(c)(7)(A)(i), or
- (ii) 125 percent of current liability (as defined in section 412(c)(7)(B)).

The determination under this paragraph shall be made as of the most recent valuation date of the plan preceding the qualified transfer.

Thus, pursuant to Code § 420(e)(2), "excess pension assets" must be actuarially determined.

Finally, Code § 420(b)(3) states that "[t]he amount of excess pension assets which may be transferred in a qualified transfer shall not exceed the amount which is reasonably estimated to be the amount the employer maintaining the plan will pay (whether directly or through reimbursement) out of such account during the taxable year of the transfer for qualified current retiree health liabilities."

Regarding the amount available for transfer from a pension plan's general assets to a Code § 401(h) account, Private Letter Ruling 200315038 states that "a governmental plan in order to comply with the requirements of § 420 of the Code must determine the amount of available excess assets available for transfer in accordance with § 420(e)(2) of the Code, and therefore must make the determinations provided for in §§ 412(c)(7)(A)(i), 412(c)(7)(A)(i) and 412(c)(7)(B) of the Code, notwithstanding the general exclusion of governmental plans from § 412." Regarding the adequacy of pension plan funding in order to be eligible to make a transfer of assets to a 401(h) account, the Court in Chemtech Industries, Inc. v. Goldman Financial Group, Inc., 809 F.Supp. 729 (E.D.Mo. 1994) stated that

"[t]he appropriate test for determining adequacy of funding after a § 420 transfer is whether there are sufficient funds remaining in the plan to cover current liability, the obligation to fund the benefits of the participants as they come due. This standard takes into account the fact that the plan will continue as an on-going plan and not be terminated in the near future. This is the standard set forth in 26 U.S.C. § 412 and specifically incorporated into § 420."

4. Applicable Law – Prohibited Transaction Issue

A tax-exempt organization will lose its exempt status if it engages in a "prohibited transaction." Section 501(a) provides as follows:

"(a) Exemption from taxation

An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503."

Code § 503(b) describes a prohibited transaction as follows:

“(b) Prohibited Transactions

For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section--

- (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;
- (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
- (3) makes any part of its services available on a preferential basis to;
- (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;
- (5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or
- (6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.”

The prohibited transaction rules are further explained in Treas. Regs. § 1.503(b)- 1(a) as follows:

“The term prohibited transaction means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of § 1.503(a)-1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4)) of an individual who is such creator of or such

substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor."

With respect to the ramifications of committing a prohibited transaction, Code §503(a) states as follows:

(a) Denial of exemption to organizations engaged in prohibited transactions

"(1) General rule

(A) An organization described in section 501(c)(17) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after December 31, 1959.

(B) An organization described in section 401(a) which is referred to in section 4975(g) (2) or (3) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after March 1, 1954."

Code § 4975(g) makes it clear that tax-qualified government retirement plan are subject to the prohibited transaction rules of Code §503(a) and (b). Specifically, Code § 4975 states as follows:

"(g) Application of section

This section shall not apply -

- (1) in the case of a plan to which a guaranteed benefit policy (as defined in section 401(b)(2)(B) of the Employee Retirement Income Security Act of 1974) is issued, to any assets of the insurance company, insurance service, or insurance organization merely because of its issuance of such policy;
- (2) to a governmental plan (within the meaning of section 414(d))."

IV. DISCUSSION OF SPECIFIC FINDINGS AND ISSUES

A. Manager's Proposal 1

1. Summary of Conclusions

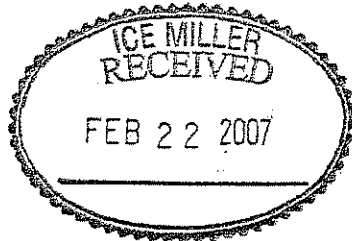
Based on the evidence developed by Navigant Consulting and discussed in earlier Sections of this Report, we have concluded that the Board acted improperly in approving MP 1. To the extent MP 1 permitted the City to fund the Retirement System on a basis that was not actuarially based, it violated state and municipal law and was a breach of fiduciary duty by the Board.

Exhibit 9



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION



February 20, 2007

Ice Miller
Attn: Mary Beth Braitman/Terry A.M. Mumford
One American Square- Suite 3100
Indianapolis, IN 46282-0200

Local contact address:
Internal Revenue Service
TE/GE: EP: VC 7554
Attn: Paul C. Hogan
915 2nd Ave.-MailStop 510
Seattle, WA 98174
Telephone: 206-220-6085
Fax: 206-220-6071

RE: VCP Submission Case #911659038 for San Diego City Employees'
Retirement System and related Form 5300 Determination Letter Application

Dear Ms. Braitman & Ms. Mumford:

As mentioned in last week's letter dated February 13, 2007 we reserved the right to raise additional issues or ask for more information in response to the VCP issue involving the Plan's compliance with Internal Revenue Code (Code) section 415 that was discussed in your correspondence package dated August 9, 2006.

Please consider the additional comments and requests for additional information and add them to the other six items that were detailed in our earlier letter dated 2/13/07.

VCP Submission 415(b) Submission dated August 9, 2006

7. At the bottom of page 4 and top of page 5 of your Exhibit 2 you state that the tax law change that added Code section 415(m) to the Internal Revenue Code provided that 415 was met for pre-1995 years and thus those years need not be tested. We do not believe that the wording of the tax law change leads to that conclusion. In VCP, we cannot force you to consider pre-1995 plan years specifically. However, we do believe that any reasonable compliance methodology should consider benefit payments in post-1994 years, regardless of when the payments first began. Your Exhibit 2 compliance document on page 27 suggests that a large number of retirees who received post-1994 benefit payments from the Plan were not tested for compliance with Code section 415 limits because they retired prior to 1/1/95. We do not believe that this is a reasonable methodology in determining the Plan's compliance with Code section 415 limits. Some revisions need to be made to Exhibit 2 narrative and other related exhibits. Additional testing will have

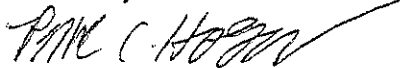
to be performed by the Plan's actuary.

8. Your Exhibit 2 contains a discussion on the group of employees who are considered "Qualified Participants" and whose Code section 415(b) limit is not reduced for early retirement that begins before age 62. In your discussion (see page 19 of Exhibit 2), it appears as if you wish to include park rangers who are not employees of a police or fire department as Qualified Participants. It does not appear that this is allowable under the Code or any published IRS Regulations. Please remove this group of participants from the group of Qualified Participants and subject their 415 limits to the early retirement reductions. Please revise your Exhibit 2 narrative and other related exhibits. If any park rangers retired during the testing period (1995-2005 plan years) they will have to be re-tested.
9. We do not agree with your statements on page five of your Exhibit 2 in regards to whether the Plan needs to consider complying with the Code section 411(c) rules. The Service believes that the 411(c) rules will apply for testing under Code section 415 upon transfer of assets from a defined contribution plan to a defined benefit plan. Please submit a correction proposal that deals with the testing period (i.e. 1995-2005 plans) and promotes future compliance. This may also require prospective amendments to the Plan document to facilitate compliance.
10. Due to the passage of PPA, the sections of your Exhibit 2 that pertain to Code section 415(n) compliance may have to be changed since some of the tax law changes are retroactively effective.
11. Your Exhibit 2, pages 8 and 9, discuss pickup contributions under Code section 414(h). This narrative should be revised to incorporate the holdings in Rev. Rul. 2006-43. Under the revenue ruling multiple elections are not permitted.
12. We have a problem with the Exhibit 2 comments on page 16 in regards to the two COLA adjustments. See Item #4 in our 2/13/07 letter. As previously noted, we believe that some sort of adjustment needs to be made to the required 415 limit.
13. Page 17 of your Exhibit 2 appears to suggest that disability retirement benefits are not excluded for IRC 415 purposes. Please clarify and explain your remarks in regards to this matter.

14. Exhibit 2, page 17, states that the plan sponsor wishes to remove the TAMRA election from the Plan. Please cite the legal authority that would allow this election, once made, to be revoked.
15. Exhibit 2, page 17 states that an 8% interest assumption was used. Please explain where this number comes from. Is it specified within the terms of the Plan?
16. Exhibit 2, page five suggests the possibility that some participants may have exceeded the limits under Code section 415(c). If that is true, then that is a separate qualification failure. Your submission should be revised to provide all of the necessary details required by Rev. Proc. 2003-44 Section 11.02.

Please respond by 3/20/2007. Should you have any questions, please call me at 206-220-6085.

Sincerely,



Paul C. Hogan
Internal Revenue Agent
Employee Plans Specialist, Voluntary Compliance
ID #93-10754

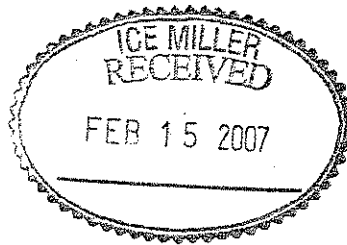
cc: San Diego City Employees' Retirement System

Exhibit 10



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



February 13, 2007

Ice Miller
Attn: Mary Beth Braitman/Terry A.M. Mumford
One American Square- Suite 3100
Indianapolis, IN 46282-0200

Local contact address:

Internal Revenue Service
TE/GE: EP: VC 7554
Attn: Paul C. Hogan
915 2nd Ave.-MailStop 510
Seattle, WA 98174
Telephone: 206-220-6085
Fax: 206-220-6071

RE: VCP Submission Case #911659038 for San Diego City Employees'
Retirement System and related Form 5300 Determination Letter Application

Dear Ms. Braitman & Ms. Mumford:

Please allow me the opportunity to apologize for the delay in getting back to you. I have reviewed your correspondence & attachments that were included with your letter of August 31, 2006 and considered the new, additional qualification failure that you submitted to the Service in correspondence dated August 9, 2006. I also looked at the documents included with the original July 12, 2005 VCP submission and its many other subsequent add-ons. The Manager of Voluntary Compliance and other officials of Employee Plans have been informally consulted in regard to this VCP submission and form 5300 determination letter application. We are all in agreement as to the next steps.

I have the following comments and requests for additional information:

VCP Submission: Presidential Leave Issue:

1. Some discrepancies were noted in your 8/31/06 response and the related Exhibits you submitted in regard to the Presidential Leave Program.

First, the POA letter of 8/31/06 on page 3 and the new Exhibit 12 included as part of your Exhibit 2 state that five union presidents have been impacted by this failure. It was noted that Ron Newman has not been listed as an affected participant impacted by this issue, and the Exhibit provides no information in regard to this individual. Yet your Exhibit 2E seems to mention this individual in connection with the Presidential Leave Program. Please explain

Second, the new Exhibit 12 Supplement that was included as part of Exhibit 2 (associated with your 8/31/06 letter) suggests that Harry Eastus was affected by the Presidential Leave Program starting on 1/1/91. However, the information in Exhibit 2E seems to indicate that he took over as union president on 3/4/89. It seems as if he would have been impacted

by this failure prior to 1/1/91. Please explain.

2. The new Exhibit 12 Supplement that was included as part of Exhibit 2 (associated with your 8/31/06 letter) does not disclose how the "Base Pension Amount, Monthly" was determined. In order to evaluate the proposed correction method for this failure, information must be submitted that shows what impact Union salary had on that computation of the "Base Pension Amount, Monthly".
3. The language in the Plan regarding the Incumbent President Program seems to indicate that the member's required employee contributions will also be based on the union salary received by the plan participant in addition to any compensation paid by the City. See Plan Document Exhibit G-10/21/02 Resolution. Are these employee contributions being picked up under Internal Revenue Code ("Code") section 414(h)? If so, is it by the City or the Union? Does Code section 414(h) allow for such an action since none of the Unions have adopted the Plan, and the picked up contributions are not coming out of City compensation?
4. In terms of the years in which the Unions paid employee contributions directly to the Plan based on union compensation paid to the union presidents, please indicate whether such contributions were picked up under Code section 414(h). If so, please explain how this is acceptable under Code section 414(h) given that none of the affected unions have adopted the Plan and the picked up contributions are not associated with any City paid compensation.

VCP Submission: IRC 401(a)(9) Minimum Distribution- DROP-June 7, 2006 Letter

After careful consideration of the original information presented in your original letter of June 7, 2006 and the additional information and comments contained in your 8/31/06 correspondence it is still uncertain from your correspondence whether you have explicitly described an actual plan document failure in regard to Code section 401(a)(9) that is applicable for the TRA'86/GUST timeframe. Your letter hints that the Plan's language in regard to the minimum distributions may not have been complete enough to satisfy the overall form requirements of the statute. While the individuals of the Service (at the August 10, 2006 meeting) did encourage the Plan to present all identified problems to the Service's VCP program there was no representation that we would ignore the program requirements that apply to VCP submissions. Rev. Proc. 2003-44 Section 10.01 states that the Service will not make any investigation or finding under VCP concerning whether there are failures. Therefore, the Service will not, under VCP, make a determination as to whether the Plan's DROP distribution options made before October 2005 adhered to a reasonable good faith compliance with Code section 401(a)(9), whether Board Rule 12.21 is acceptable under Code

section 401(a)(9) and whether Board Rule 12.20 is in compliance with Code section 401(a)(9). Nor will the VCP compliance statement contain an explicit statement as to whether the steps taken by SDCERS to revise the DROP provisions do not result in a per se violation of Code section 401(a)(9). It must be pointed out that the plan language relating to final regulations under Code Section 401(a)(9) is part of the EGTRRA remedial amendment period and this language will be reviewed when the Plan is submitted for a determination letter on the EGTRRA tax law changes in accordance with Rev. Proc. 2005-66. In terms of operational compliance, with Code section 401(a)(9) in regard to DROP, the taxpayer is free to submit a private letter ruling following the procedures set forth in Rev. Proc. 2007-4 outside of this VCP submission. In the end, your VCP submission should be revised to delete these requests. The DROP participants whose required minimum distributions did not commence on time will be fixed as originally proposed in your letter of April 19, 2006.

VCP Submission: Overpayment of Benefits-10% Disability Issue

After reviewing your initial 6/13/06 letter as well as the additional comments and information contained in your response dated 8/31/06, item 15 (pages 12 & 13), the Plan's proposal not to seek repayment from the affected participants is acceptable and makes sense given all submitted facts and circumstances. However, simply classifying the overpayments as an unfunded pension liability that will be recovered through the Plan's normal funding and actuarial procedures is not acceptable. Overpayments that are not recovered from the affected participants become the responsibility of the plan sponsor. Under EPCRS, we require the plan sponsor to reimburse the Plan for any un-recovered overpayments by making a special, immediate contribution to the Plan before the end of a specified period that is to be set forth in the terms of any compliance statement or closing agreement. Your proposed correction methodology for this failure should be revised to delete the references to increases in the Plan's unfunded liability and simply state that the overpayments will be paid to the Plan by the plan sponsor(s) through special, supplemental contributions.

VCP Submission & Determination Letter: Cashless Leave Conversion Issue

1. We have your considered your initial letter of 6/19/06 plus its attachments as well as the additional comments and information provided in your response dated 8/31/06, item 17 (pages 26-27) plus attachments. The terms of the Plan do not appear to comply with the form requirements of Code section 401(a) because the language appears to offer some plan participants a cash or deferred election (as defined in IRS Regs. 1.401(k)-1) in regard to the donation of their annual leave in exchange for additional pension benefits. Such an arrangement cannot be part of a qualified defined benefit pension under Code section 401(a). We must also point out that under the specific terms of City Ordinance 19126 that was adopted on 12/3/02 there is no indication that this benefit was to

funded via employee pickup contributions under Code section 414(h). In fact, the specific terms of the City Ordinance that created the "cashless leave" benefit clearly indicate that this is to be an unfunded pension liability. It will be funded by possible increases in the City's contribution rate and the City **will not** be transferring to the Retirement System the cash equivalent of the Annual Leave underlying the conversion to Creditable Service or the extension of the period of DROP participation in these Annual Leave conversion transactions. See City Ordinance No. 19126 adopted on 12/3/02. Given this information, it is not immediately obvious whether there is an actual operational failure involving a failure to follow the terms of the Plan as stated in your letter of 6/19/06 and its accompanying analysis. It is also not clear as to whether there is a legal obligation under the Code for the City to immediately turn over (to the Plan) \$519,163.79 that is associated with the value of the donated leave in order to fund the leave conversion benefit.

2. In order to be able to issue a favorable determination letter and resolve the open VCP submission with an acceptable correction method that fully resolves this qualification failure we are requesting that your initial VCP proposal of June 19, 2006 be revised in the following manner:
 - (a) The terms of the Plan must be retroactively amended to remove this benefit from the Plan.
 - (b) SDCERS will have to revise their records and remove the additional benefits and service that were generated by the donated leave from all affected participants. This applies to DROP and non-DROP benefits. If overpayments have been made by the Plan then it will have to try and recover any overpayments
 - (c) The City will have to restore the donated leave to the affected participants if they are still employed by the City. If the affected participants are no longer employed by the City then the City will have to make a cash payment to the employee. Such a payment will be considered as taxable compensation.

VCP Submission & Determination Letter Application: 401(h) Issue

1. After reviewing your initial 6/22/06 letter as well as the additional comments and information provided in your response dated 8/31/06, item 19 (pages 14 through 17 plus several Exhibits) and the DL Item 23 (page 31), the terms of the Plan and the Plan's operation did not comply with the form and operational requirements relating to Code section 401(h) and Code section 401(a)(2) especially given the express terms in the 3/31/97 City ordinance and Plan section 24.1502(a)(5). In the end, plan assets were indirectly used to pay for the 401(h) benefits at all times, and this design did not allow the Plan to comply with Code sections 401(a)(2) & (401(h)). We do not agree with your assertion that the \$63,462,590 in 401(h) contributions associated with

the 1997-2002 plan years is simply a funding shortfall that should be recovered through the Plan's normal funding and actuarial procedures.

2. In order to have an acceptable VCP correction method that fully resolves this qualification failure we are requesting that your initial VCP proposal of June 22, 2006 be revised in the following manner:

- a. The \$63,462,590 must be described as an immediate obligation to the Plan that must be paid to the Plan by the City and that it will not be treated as an unfunded pension liability. Like the other amounts associated with this failure, the City must agree to repay this amount to the Plan on a faster schedule as discussed further on page seven of this letter, and it must be added to the other amounts described in your letter of 6/22/06 that are owed to the Plan. Therefore, the corrective amount that is owed to the Plan as a result of the described 401(h) failure has increased by \$63,462,590 (before interest). This amount will have to be adjusted for earnings through the date of correction and be added to the other amounts associated with this failure that are considered immediate obligations. Please include revised exhibits that document the amount to be repaid the Plan as a result of the 401(h) failure.
- b. In order to fix the plan document failures, the terms of the Plan need to be retroactively amended to remove all mention of Code section 401(h), section 24.1502(a)(5) and any other language that states that the Plan would pay for health benefits with plan assets. A revised corrective amendment needs to be submitted.

VCP Submission 415(b) Submission dated August 9, 2006

1. In regard to the 29 participants who received overpayments in excess of the Code section 415(b) limits, the initial correction proposal seems incomplete. The sole burden of correction is being placed on the plan sponsors to restore these overpayments to the Plan. Given, the repayment burdens on the plan sponsor caused by some of the other operational failures; please provide a detailed explanation as to why the Plan does not first attempt to recover the overpayments from the affected participants using one of the methods in Rev. Proc. 2003-44 Appendix B Section 2.04(1)(a)(i) and (ii). It seems as if this correction proposal should be revised.
2. If the excess payments are not recovered from the affected participants then the Plan must follow the notification procedures set forth in Rev. Proc. 2003-44 Section 6.06 in regard to the excess amounts that they received from the Plan. Please revise this correction proposal to comply with EPCRS correction principles in

regard to this matter.

3. Your letter of 8/9/06 and its attachments indicate that the calendar year was used to determine limits under Code section 415. However, this clearly conflicts with the express terms of the Plan as set forth in Section 24.1010(b)(6). The terms of the Plan (in effect during the period of failure) clearly indicates that the Plan's limitation year is the fiscal year beginning on July 1 through June 30. This is a perfectly valid limitation year and we would expect all compliance testing to be based on the Plan's limitation year. There is no legal basis that would allow you, the Plan's actuary or the Board the right to ignore the express terms of the Plan. Nor, at first impression, is there any authority under the Code or EPCRS that would allow the Plan's limitation year to be changed (on a retroactive basis) given that no actual testing was done prior to 2006. Of course, if you wish to prospectively amend the Plan and change the limitation year you may do so. However, until that discretionary amendment is actually adopted; the fiscal year limitation year must be used in determining a participant's limit under Code section 415. In order to determine whether you have corrected this failure, your compliance testing for determining past IRC 415 limits in past years will have to be redone using the July 1 through June 30 as the limitation year. If the numbers change, a new Exhibit F will have to be submitted. Given the date of your submission we expect your analysis to include all retirees through June 30, 2006. The correction narrative in your cover letter and analysis document will also have to be revised.
4. The analysis in your letter of 8/9/06 and the Plan terms indicate that this Plan provides for COLA benefits/increases. We do not agree with your conclusion that COLA benefits have no impact in the determination of a participant's maximum benefit under Code section 415(b) (page 13-14). We expect you to take into account the Plan's COLA benefits into consideration when determining a participant's maximum 415(b) limit. Generally, this will call for an initial reduction in the participant's maximum 415(b) limit. In order to resolve this issue under VCP, please take the following actions:
 - (a) Please revise your correction methodology narrative to take into account COLA and its impact in determining limits under Code section 415(b).
 - (b) The compliance review for the old plan years will have to be revised taking into account the effect of COLA and its effect on a participant's initial 415(b) limit. The compliance review will have to be redone and new

Exhibits, including Exhibit F will have to be submitted.

- (c) The terms of the Plan document will have to be amended to contain proper language in regard to the coordination of the COLA adjustments/benefits and its impact on the maximum limit under Code section 415(b).
- 5. The testing procedure set forth in Exhibit A and methodology narrative needs to be clarified to say that 8% interest will not be used for post retirement adjustments to the maximum dollar limit if retirement benefits begin after the participant reaches age 65.
- 6. The correction narrative on page 19, in regard to item (d) should be revised and clarified to say that the specified exception only applies to pre-retirement disability benefits. It cannot be applied to disability benefits that are paid by the Plan after the participant "retires" with a disability pension.
- 7. Due to the complexity of this VCP issue, the length of your analysis and your numerous exhibits we reserve the right to raise additional questions and concerns in regard to this issue.

VCP Submission- Request for a five year Repayment period for Amounts owed to the Plan associated with the 401(h) health benefits-retiree health expenses and the 415(b) failure.

We have carefully considered your request to allow the plan sponsor to have a five year repayment period in order to reimburse the Plan for the payment of City expenses, or certain employee contributions that were turned over to the Plan or to restore overpayments that were mistakenly paid to some plan participants. We believe that the requested repayment period is too long given the limitations of the VCP program and is not consistent with how we have handled similar requests in past EPCRS situations. Given all of the facts and circumstances, a more reasonable repayment period that could be allowed under VCP would be approximately 18 months. Five years is just too long. Please revise your correction proposals to call for a shorter repayment time. Please remember to include this reasonable repayment period for the amounts owed as a results of the overpayments associated with the Plan's 10% disability benefit and the additional amounts owed that are associated with the 401(h) retirement health expenses failure and the 415(b) overpayments.

New Operational Failure for VCP (Item 20 of your 8/31/06 letter, page 17)

I have reviewed your 8/31/06 letter (page 17) along with Exhibit 26 and your other letter of 6/22/06 with its Exhibit A. You have clearly described an operational failure where Plan provided benefits to certain individuals that were not in accordance with the terms of the Plan in the 2004-2006 plan years. Under the Internal Revenue Code, a qualified plan must operate in accordance with the

terms of a written plan document. Changes in a state law do not override this basic requirement of the Internal Revenue Code. If the Plan has to change its operation to comply with a state law or some court case then the plan sponsor needs to amend the Plan by the end of the plan year in which such changes were effective. Under the Code these changes are considered discretionary changes. Given your own disclosure of the issue, please add this failure to the VCP submission and revise the Exhibit 26 amendment to contain the proper retroactive effective dates that conforms the plan document to the Plan's operation in regard to this specific matter. I call your attention to Rev. Proc. 2003-44 Section 12.08(4)(b). The plan document cannot be changed retroactively under the Internal Revenue Code unless the Plan is retroactively amended to apply these discretionary changes, and only certain programs under EPCRS allow this action to occur. A change in Administrative procedures will have to be made in order to ensure that needed discretionary amendments to the Plan document are drafted timely and adopted by the plan sponsor in a timely manner so that the plan document conforms to changes in the Plan's operation.

Form 5300 Application Issues-

1. Given the existence of the Technical Ordinance (See Exhibit 26 associated with your letter of 8/31/06) and the comments in your letter of 8/31/06 (page 20) it is obvious Plan's terms did not fully comply with all of the form requirements imposed by Code section 401(a). Some of the failures were discovered by your office and others were uncovered during the initial review of the form 5300 application by the Service. The Plan has never received an IRS determination letter and the remedial amendment period for TRA'86/GUST has been closed for some time. Many of the identified plan document defects go back to the effective dates of TRA'86/GUST. In order to fix the plan document defects many of the changes in the Exhibit 26 proposed amendment to section 24.1004 must have retroactive effective dates in order to fix identified problems with the plan document. Since the Code section 401(b) remedial amendment period has expired for TRA'86/GUST tax law changes the Plan cannot be retroactively amended to fix identified plan document failures unless the VCP submission is expanded. Please note that a favorable TRA'86/GUST determination letter cannot be issued unless the Plan is retroactively amended to fix the plan document failures. Please expand the VCP submission to acknowledge the plan document failures.
2. In terms of your Exhibit 2 that is associated with your letter of 8/31/06 it is not clear if a good faith EGTRRA amendment was adopted timely to implement the higher compensation limits associated with Code section 401(a)(17) and for the QDRO rules of Code section 414(p) that now apply to governmental plans. It would seem as if some sort of EGTRRA good faith should have been adopted by the end of the GUST remedial amendment period or the end of the 2002 plan year. If there is a chance, that some required interim, good faith amendments for EGTRRA were not timely

adopted by the plan sponsor then please expand the VCP submission to include the additional failure.

3. Many of the amendments that are part of Exhibit 26 need to have retroactive effective dates. Currently, some of the corrective amendments do not have an effective date. Some of the proposed changes should be effective as of 7/1/89 while others may have a different date. Please revise the amendment to contain the correct effective dates.
4. Our prior letter raised concerns on whether section 24.0103 & 24.0902 of the Plan complied with Code section 401(a)(25) & Rev. Rul. 79-90. In your response (8/31/06 letter, page 21) you have proposed to have the Board adopt these factors via a "Board Rule". Since these "Board Rules" are to be part of the plan document you must submit these documents to us so that they can be part of the proposed amendment and be associated with the determination letter application. They must also be evaluated for compliance with the above rules. The Board rules must specify the interest rates, mortality tables that have been used July 1, 1989. We must point out that Board rules that are drafted like your Exhibit 18 (associated with your letter of 8/31/06) are not definitely determinable and will not satisfy this requirement.
5. Our previous letter raised concerns about whether several of the Plan's provisions provide definitely determinable benefits as required by Code Section 401(a) and IRS Regs. 1.401-1(b). In your response (8/31/06 letter, pages 21-22 & pages 27-28) you have proposed to have the Board adopt employee contribution rates, and interest paid on employee contributions via a "Board Rule". Since these "Board Rules" are to be part of the plan document you must submit these documents to us so that they can be part of the proposed amendment and be associated with the determination letter application. They must also be evaluated for compliance with the above rules. The Board rules must specify the rates that have been used July 1, 1989. We must point out that Board rules that are drafted like your Exhibit 18 (associated with your letter of 8/31/06) are not definitely determinable and will not satisfy this requirement.
6. The DROP language that is present in plan section 24.1404(c)(6) is not definitely determinable and it needs to be addressed. Some sort of retroactive amendment will have to specify the rate or rates that have been used since the DROP was added to the Plan up through the current plan year. Similar to earlier items #4 & 5.
7. After reading your response in regard to the questions involving the Plan's death benefits (see 8/31/06-Pages 22-24) the terms of the Plan should be amended to contain a specific overall cap on the total amount of death benefits that will be provided by the Plan. This will ensure that the Plan

terms are consistent with the requirement of IRS Regs. 1.401-1(b)(1)(i) with the incidental death benefit limitation. The use of one of the specific methods mentioned in your 8/31/06 letter would be acceptable. Please make this provision retroactively effective as of 7/1/89.

8. We have reviewed the proposed amendment (Exhibit 26-associated with your letter of 8/31/06) in terms of the new language for compliance with Code section 401(a)(17) and page 24 of your cover letter. It is not clear if the proposed corrective amendment allows the Plan to meet Code section 401(a)(17) limits.

(a) As noted in some of the other questions, the referenced Board rules were not included with the amendment. They must be submitted and made part of the proposed amendment and reviewed as part of the DL application. Please submit the missing documents and please keep in mind the rule on definitely determinable benefits.

(b) We do not believe that the family aggregation rules can be incorporated by reference. Also, the language in the amendment is not very clear that such provisions were only effective in the 1996 plan year. Please submit a revised amendment.

9. As noted in the VCP item relating to the "cashless leave" issue, the language in the Plan must be retroactively amended to remove this benefit from Plan sections 24.1310(c), 24.1402 through 24.1404 and any other applicable plan section that references this benefit.
10. As noted in the VCP Item relating to the 401(h) issue, the language in plan Article 24 Division 12, Section 24.1502(a) and other places in the plan should be retroactively removed from the terms of the plan document. A revised corrective amendment is needed. The language in the Plan does not meet the form requirements of Code section 401(h) and 401(a)(2).
11. The definition of IRC 415 compensation that is part of the proposed amendment (Exhibit 26 of your 8/31/06) is still not acceptable for the following reasons:

- (a) No retroactive effective date.
- (b) The wording in the proposed amendment is still not definitely determinable since there are two choices in this regulation (1.415-2(d)(11)(i) or (ii)). Also, the term "W-2 income" is not used in the regulation. Please choose one of the definitions of compensation that is in this regulation and please do not use terms that are not referenced in the regulations.
- (c) The amendment did not include the exclusion relating to 414(h) contributions.

- (d) The amendment did not include the GUST inclusions effective in the 1998 limitation year in regard to increasing the definition of compensation for IRC 415 purposes as noted in Code section 415(c)(3). Also, lacking is the additional adjustment that was added by CRA'00 effective in the 2001 or 2002 limitation year.
 - (e) Given Participant's ability to purchase service credit, the Plan may need to add the IRC 415(c) limits. It is unclear if the specific proposed amendment language on page 16, item 3 meets this requirement.
12. In terms of the change to the Plan's definition of "Limitation Year", the proposed amendment is not acceptable because it does not contain an effective date.
13. As noted in the VCP item relating to the IRC 415(b), (c) & (n) issues, the language in the Plan must be retroactively amended to further comply with Code Section 415 limits.

Miscellaneous Issues:

Due to the complexity of the VCP submission and the related determination letter, we reserve the right to raise additional questions and concerns.

Please respond by 3/14/2007. Should you have any questions, please call me at 206-220-6085.

Sincerely,



Paul C. Hogan
Internal Revenue Agent
Employee Plans Specialist, Voluntary Compliance
ID #93-10754

cc: San Diego City Employees' Retirement System